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Chairman of the Surface Transportation Board
Senate Committee on Commerce, Science, and Transportation
Subcommittee on Surface Transportation and Merchant Marine
Hearing on Economics, Service and Capacity in the Freight Railroad Industry
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Good morning Chairman Lott, Ranking Member Inouye, and Members of the Subcommittee. My name is Douglas Buttrey, and I am Chairman of the Surface Transportation Board (Board or STB). I appreciate the opportunity to appear before this Subcommittee today to discuss the economics of the freight railroad industry as it relates to current service and capacity issues.

This is my first appearance before this Subcommittee since I became Chairman of the STB on January 5, 2006. The issues that are the subject of this hearing are vitally important to the freight railroads, their customers and employees, and the nation's freight transportation system as a whole. I commend the Subcommittee for holding this hearing to look into these important matters.

I understand that a representative of the Government Accountability Office (GAO) is also scheduled to testify at this hearing, to present preliminary findings from GAO's study of recent rate changes in the freight rail industry. The Board has been cooperating with GAO on this study, and several meetings have been held between GAO and Board staff on this subject, to discuss the background and exchange information. Board staff has shared with me the contents of a preliminary draft statement of facts from GAO's study. Board staff is currently analyzing that preliminary draft. Once they have completed their analysis they will share it with GAO.

First, I will provide an overview of the Board and its responsibilities, and then I will discuss steps the Board is taking to address the issues that are the focus of this hearing.

Overview of the STB

The STB was created over 10 years ago by legislation initiated by this Committee. The ICC Termination Act of 1995 (ICCTA) established a three-member Board and charged it with the fundamental missions of resolving railroad rate and service disputes and reviewing railroad restructuring transactions (mergers, line sales, line construction, and line abandonments). In addition, the Board was given limited jurisdiction over certain trucking, bus, household goods, ocean shipping company (non-contiguous domestic trade), and pipeline matters. It is important to note that the substantial deregulation effected in the Staggers Rail Act of 1980 was continued under ICCTA. ICCTA empowers the Board, through its exemption authority, to promote deregulation through administrative action. The Board's staff is limited to no more than 150 employees by appropriation.

Two of the Board's main functions are to provide a regulatory forum to address rate disputes between railroads and captive shippers, and to assist shippers with service issues. The Board has created a number of mechanisms to help railroads and their customers resolve disputes before availing themselves of the Board's formal processes. For example, the Office of Compliance and Enforcement operates the Rail Consumer Assistance Program. That program is intended to provide assistance to rail consumers in addressing those issues that have not been resolved through private negotiations. When informal processes cannot produce a solution, however, the Board is available to provide an adjudicatory forum.

Although rates throughout the rail industry have generally declined significantly since the Staggers Act, many shippers believe the Board has not done enough to address shipper concerns in the areas of rate and service disputes. I understand those concerns, and I will next relate the steps the Board is taking to address them.

Shipper Issues

1. Undercapacity

Before I discuss rate and service issues in more detail, I would like to express my view of what it is that makes at least some of today's problems somewhat different from the issues that prevailed when the Board last appeared before this Subcommittee. Historically, railroads were burdened with excess capacity, which made it difficult for them to operate efficiently and earn a profit. In recent years, railroads have become more efficient by rationalizing their systems. At the same time, however, the U.S. economy has expanded, and the railroad industry, like other transportation sectors, has become capacity-constrained in some areas. Unlike some other sectors, however – trucking companies, for example, which can buy new equipment or hire more drivers – railroads cannot as readily respond to capacity constraints by quickly building new track and other facilities. Not only are rail construction projects expensive and time-consuming, but – as I will discuss later – these projects often are extremely controversial and can be the subject of court challenges on environmental issues in particular.

For those reasons, and others that may be beyond their control, railroads have experienced intermittent service problems throughout their systems. To mitigate the effects of their undercapacity, they have reportedly begun rationing service occasionally. According to some shippers, they do this by either embargoing large classes of traffic or by raising rates selectively. Neither of these alleged practices has been brought formally before the Board, and whether the Board could afford relief would depend on the circumstances of any formal complaint that might be brought. If a particular shipper has access to truck service – even if that service might be more expensive or less convenient – it might be unable to meet the market dominance requirement that is a statutory prerequisite to rate relief. And although the statute

requires railroads to provide service on "reasonable request," what is reasonable is a case-specific inquiry. Railroads must prioritize competing requests for service, and I cannot say in advance how the Board would rule on any particular complaint alleging that a particular railroad's prioritization was so unreasonable as to be unlawful.

In any event, these concerns might be mitigated if railroads were able to expand their capacity. Such capital planning decisions depend on a variety of factors, such as the cost of new facilities, the likely returns on investment in new facilities, the availability of Federal and state programs to support and/or incentivize infrastructure capacity expansion by freight railroads, and so forth.

2. Rate Disputes

Under the statute, the Board has exclusive jurisdiction to resolve rate disputes in those instances when a railroad has market dominance – in other words, when the railroad is charging a rate higher than the regulatory floor and the shipper has no effective transportation alternative. Under the Interstate Commerce Act, the Board must balance the often conflicting objectives of assisting railroads in attaining revenue adequacy, on the one hand, and ensuring that the rates that individual shippers pay are reasonable, on the other. The balance, as we all know, is not an easy one. Rates that are too high can harm rail-dependent businesses, while rates that are held down too low will deprive railroads of revenues to pay for the infrastructure investments needed to give shippers the level and quality of service that they require. The Board has one set of procedures for handling "large" rate cases and another for "small" cases.

a. Large Rate Cases

The first step in a rate case is a two-part inquiry to determine whether the railroad has "market dominance" over the transportation to which the rate applies. The first part of the

inquiry is to determine the "variable costs" of providing the service. The statute establishes a conclusive presumption that a railroad does not have market dominance over transportation if the rate that it charges produces revenues below 180% of the variable costs of providing the service, which means that this 180% revenue-to-variable cost (R/VC) percentage is the floor for regulatory scrutiny.

If the rate the railroad charges exceeds the 180% R/VC threshold, the second part of a market dominance inquiry involves a qualitative assessment in which the Board must determine whether there are any feasible transportation alternatives that could be used for the traffic involved. The Board considers whether there is actual or potential direct competition – that is, competition either from other railroads (intramodal competition) or from other modes of transportation such as trucks, pipelines, or barges (intermodal competition) for transporting the same traffic moving between the same points. If there are effective competitive alternatives for the transportation, then the Board does not have jurisdiction to regulate the rate, even if the rate charged yields an R/VC ratio greater than 180%.

If the shipper can show that the railroad is market dominant, then the Board applies its court-approved methodology for rate review known as constrained market pricing (CMP) to assess whether the rate being charged that shipper is in fact unreasonable. CMP provides a framework for the Board to regulate rates while affording railroads the opportunity to cover their costs. CMP is premised on differential pricing, that is, pricing based on the demand for the service provided. CMP principles recognize that, in order for railroads to earn adequate revenues, they need the flexibility to charge different customers different prices based on each customer's demand for rail service. But CMP principles also impose constraints on a railroad's

ability to price. Despite the complexity of CMP, the courts have held that it is the most desirable available approach to railroad rate review and that the Board must use it whenever it is feasible.

The most commonly used CMP constraint is the stand-alone cost (SAC) test. Under SAC, a railroad may not charge a shipper more than what a hypothetical new, optimally efficient carrier would need to charge the complaining shipper if such a carrier were to design, build, and operate – with no legal or financial barriers to entry into or exit from the industry – a system to serve only that shipper and whatever group of traffic that shipper selects to be included in the traffic base. The ultimate objective of the SAC test is to ensure that the complaining shipper is not charged for carrier inefficiencies or for facilities or services from which the shipper derives no benefit. As with CMP in general, this assures the complaining shipper that it is not required to pay for inefficiencies or to unfairly subsidize other customers of the railroad.

I am aware that some shippers believe that the deck is stacked against them in rate cases brought under SAC. Yet, the Board's rate decisions historically have divided about evenly in terms of shipper wins versus carrier wins. I have attached a table setting forth this information as Exhibit A. Furthermore, nearly all of the Board's rate decisions that have been challenged in court – whether challenged by railroads or by shippers – have been affirmed.

Nevertheless, the Board is working very hard to reform the large rate case process, in an effort to make it as fair, efficient and user-friendly as possible, given the somewhat competing statutory objectives. It is undeniable that deciding large rate cases is time consuming and costly for both the parties involved and the Board. The Board by statute has 9 months after the close of the record to decide a large rate case, and it can take more than twice that long after the shipper files its complaint for the parties to file all their evidence with the Board. Preparing that evidence and presenting it to the Board can be very time-consuming and expensive for the

parties, and the Board devotes a significant amount of staff time and resources to these cases as well.

In recent years, the Board has developed new ways to simplify and speed up the rate review process. It has provided for: non-binding mediation at the beginning of the case, under the Board's auspices, between the shipper and the railroad; expedited procedures to resolve disputes, using Board staff, over what information the parties can be required to give to each other during discovery; technical conferences to resolve, before the actual evidence is filed, certain factual disputes between the parties using the expertise of Board staff; and public versions of all filings with the Board that can protect confidential information but still be read and understood by all parties and the public. These new procedures have for the most part improved the process by helping to move large rate cases forward.

Since I became Chairman, our staff has reviewed the rate proceedings the agency has processed over the past few years, and the Board has issued a Notice of Proposed Rulemaking (NPR) in an attempt to improve how we handle certain difficult substantive issues that have come up. In particular, we are seeking comments on six proposed changes to large rate case procedures. Those changes would focus on how the SAC process ought to arrive at the maximum reasonable rate once it is determined that an existing rate is too high; how the SAC process can better reflect economies of density; how the SAC process can better reflect carrier productivity gains when forecasting future carrier costs; how to simplify the costing process; how to improve the "discounted cash flow" analysis used to calculate the need for rate relief; and better procedures for reopening or vacating a prior Board decision in SAC cases.

Comments and replies have already been filed, and rebuttals are due shortly. Because of the scope of these proposed rule changes, the Board has put its pending large rate cases in

abeyance. Things are not standing still, however. Recently, the Board issued compliance orders in two of the pending SAC cases, to obtain additional evidence that will be needed to resolve those cases regardless of whatever rules are ultimately adopted.

In sum, while major litigation of the type involved in large rate cases is expensive and may appear to be slow, the Board has made progress in helping to ensure that the rate cases before it can proceed faster, cheaper and better. I will make it a priority to continue to make more improvements in this area. I expect significant progress when the pending rulemaking is completed.

b. Small Rate Cases

In 1996, in response to a Congressional directive, the Board adopted simplified guidelines for assessing the reasonableness of challenged rail rates in cases in which a full SAC presentation is too costly. Under these guidelines, the reasonableness of a challenged rate is determined by examining the carrier's overall revenue needs, how the railroad prices its other captive traffic, and how railroads in general price comparable traffic.

Shippers have expressed various concerns over how these procedures would play out in a particular case. They say that the ambiguity of who would qualify to use the small rate case procedures is a serious hurdle that has kept them from bringing cases. They have expressed concerns about how railroads might use the discovery process to unreasonably draw out a case. And shippers (and railroads) have urged the Board to adopt a more precise and predictable rate standard for small cases.

The agency held public hearings on this matter, and its staff met with staff from other economic regulatory agencies to gather information on how they handle smaller disputes. When a small rate complaint was filed last year – the "BP/Amoco" case – we modified some of our

processes to make the case move more smoothly. We also provided for agency mediation. We were pleased to see that, largely as a result of these measures, the parties were able to settle the BP/Amoco case at an early stage.

But I know that more needs to be done in the small rate case area, and our staff is continuing to work hard to improve the existing procedures where we can. I cannot give you a particular date on which an NPR will be issued, but I assure you that we are trying to come up with better procedures in this area. I have directed staff to work up a recommendation and would expect a proposal to be issued later this summer.

3. Fuel Surcharges

One matter that has concerned shippers in recent months relates to railroad fuel surcharges. Recent unpredictability, volatility, and spikes in fuel costs are well known. As fuel is a substantial component of railroad costs, carriers have sought to recover their increased fuel costs through surcharges. Many in the shipper community, however, have expressed concern with the way in which these fuel surcharges have been implemented. To give parties on both sides an opportunity to address these matters, on May 11, 2006, the Board held a public hearing. The hearing was well attended, and I found the testimony to be very thoughtful and enlightening. The Board is presently considering what action would be appropriate and helpful in this area.

4. Competitive New Services

Many shippers would like to obtain service from a second, competing railroad. Sometimes rail customers may work with a second railroad to apply for authority to construct a new rail line. The Board's experience over the past several years has shown that new line construction – and there have been several new line constructions over the past few years – can bring competition while maintaining the private-sector characteristics of our rail system. But it

can also be costly, and rail constructions, more than almost any other rail activity, generate community concerns that can delay and complicate the process.

The Board must take two regulatory steps before the construction of a new rail line can occur. First, the Board's environmental staff must conduct the necessary environmental review of the project. Second, the Board must consider and balance environmental concerns and the transportation-related merits of the proposed addition to the rail network. The Board has worked hard to expedite consideration of requests to construct rail lines whenever possible, and to approve them when appropriate.

Three of the most controversial projects that the Board has recently addressed are the "DM&E," "Bayport Loop," and "Tongue River" cases. In DM&E, the Board, after an extensive environmental review, approved the construction by the Dakota, Minnesota and Eastern Railroad of a line into the Powder River Basin in Wyoming, which, if constructed, will provide enhanced rail transportation options for coal shippers, particularly in the Midwest. The United States Court of Appeals for the Eighth Circuit found on judicial review that the Board had done "a highly commendable and professional job," but it nonetheless remanded the matter to the agency for limited additional consideration of four environmental issues. In a decision issued a few months ago, the Board addressed the issues remanded by the court. The Board's most recent decision has again been challenged in court by environmental and local groups, and construction of the line has not yet begun.

In Bayport Loop, the Board approved the construction of a line to provide BNSF Railway Company access into the Bayport industrial area near Houston, to bring competition to the service provided by Union Pacific Railroad Company (UP) to the large concentration of chemical companies located there. After the project was approved, it was tied up in Texas state

courts by zoning and other land use objections raised by the City of Houston. Ultimately, the construction became unnecessary when UP and BNSF announced that they had reached agreement to provide these shippers with access to both railroads over the existing UP line.

In Tongue River, the Board is now considering the latest version of a longstanding construction case designed to provide a more efficient route for coal from the Powder River Basin to electric utilities. Two portions of the Tongue River Railroad's project to construct and operate a new railroad line in Montana were approved several years ago by the Board's predecessor agency, the Interstate Commerce Commission, and then the Board. However, the project did not go forward as originally proposed, and the carrier presented the Board with an amended proposal for part of the construction. The Board's environmental staff is currently completing its final environmental document. The agency will then determine whether it should approve the redesigned project.

While build-ins can increase competition and provide many benefits, we have seen that at times the construction of new rail lines can be controversial in the communities where the construction would take place. Indeed, both DM&E and Bayport Loop generated extensive local opposition and spawned court challenges by various citizen and other groups, and environmental issues have also been raised in Tongue River.

5. Service Issues

As with other industries, railroads and shippers sometimes have disputes over service. The Board has a very active consumer assistance program that handled a total of 121 disputes during 2005. We cannot always resolve the issues, but we are often successful at bringing the parties closer together and getting them to talk to each other.

The Board has rules that allow us to temporarily substitute a new carrier for an existing carrier that is unable to provide adequate service. We have used those rules several times in the past few years, and we will use them again when appropriate. But I must point out that those rules are not a viable remedy for many of the service issues we see today, because if a line is already clogged up with too much traffic, putting another railroad on the line will not fix the problem and may even present problems of its own. Therefore, while our substituted carrier rules may be very helpful in certain circumstances, probably the best way to address service problems long-term is for new infrastructure to be added to the rail system.

6. Preemption.

As you all know, in ICCTA, Congress strengthened the statutory preemption provision that protects railroads from most state and local regulation. Although it may not be the subject of this hearing, I know that preemption is an issue that has concerned many Members of Congress in recent months. I will not go into the preemption issue in much detail here, but I would like to emphasize a few important points.

First, concerned parties always have avenues of recourse if they think Federal preemption is being improperly asserted. They can raise their concerns before the Board in a proceeding that requires a license, or through the Board's declaratory order process where no license is required; or they can choose to go directly to a court. Emergency relief can be, and has been, sought and obtained promptly in each forum.

Second, Federal preemption applies only to rail activities that are conducted by a railroad or its agent, and that are part of "railroad transportation" as defined in the statute. The Board has demonstrated its vigilance in making these fact-specific determinations in the individual cases

that have been brought before it, to ensure that only those operations that qualify for the Federal preemption will benefit from it.

Third, even where Federal preemption applies, Federal environmental laws remain applicable, including those that are implemented in part by the states such as the Clean Air Act, the Clean Water Act, and the Solid Waste Disposal Act. In addition, states and local entities clearly retain their reserved police powers.

7. Paper Barriers

The Board has also scheduled a public hearing to hear views on the issue of "paper barriers." This hearing, on July 27, 2006, will explore the pros and cons of these limitations on interchange that have been imposed in connection with some railroad line sales. After the hearing the Board will consider what, if any, action should be taken.

8. Initiatives Concerning Abandonments and Exemptions

Lastly, I want to briefly inform the Subcommittee about some other initiatives that the Board is pursuing that may improve the regulatory process.

The Board instituted a rulemaking proceeding proposing to change the timing for "class exemptions" that provide an expedited process for obtaining authority for some rail lines acquisitions, leases, and similar transactions. The Board proposed the changes to extend the opportunity for the public to raise concerns before the Board in these types of cases. Comments and replies have just recently been filed.

Additionally, the Board issued an Advance Notice of Proposed Rulemaking and sought comments on a proposal filed by a group of short line and regional railroads. They seek a new, expedited process for abandonment of rail lines owned by Class II and Class III railroads.

Comments and replies have been filed, and the Board will now consider what action, if any, is appropriate.

Neither of these proposals, if adopted, would dramatically change the fabric of transportation regulation, but both proceedings have been initiated to address areas of concern. The abandonment proceeding was instituted after small carriers raised concerns that the current procedures impose undue hardships on them, while the timing changes to the exemption process were proposed to ensure that the public is given notice of a proposed transaction before the exemption can become effective.

Conclusion

The Board is striving to address the concerns raised by captive shippers, and has several important initiatives underway that are intended to do just that. Reforms such as these are, in my view, the best way to address the concerns raised by captive shippers while maintaining a healthy freight rail network. It is a difficult balance, but one that can be achieved.

I appreciate the opportunity to discuss these issues today, and look forward to any questions you might have.

STB Rail Rate Case Results

- **Shipper showed rate unreasonable** (Board ordered reparations for shipments moved while case pending & prescribed rate for future shipments)**:**

  1. *Arizona Pub. Serv. Co. et al. v. Atchison, T.&S.F.R.R.*, 2 S.T.B. 367 (1997), *modified,* 3 S.T.B. 70 (1998) — reparations (approx. $23 million) & rate prescription (approx. 40% reduction); rate prescription lifted in 2004 due to changed circumstances (earlier-than-expected depletion of coal reserves at mine).

  2. *West Texas Util. Co. v. Burlington N. R.R.*, 1 S.T.B. 638 (1996), *reparations calculated,* 2 S.T.B. 683 (1997), *aff'd sub nom. Burlington N.R.R. v. STB*, 114 F.3d 206 (D.C. Cir. 1997) — reparations (approx. $11.4 million) & rate prescription; prescription revised in 2003 to correct for error.

  3. *FMC Wyo. Corp. et al. v. Union Pac. R.R.*, 4 S.T.B. 699 (2000) — reparations & rate prescription (approx. 15% reduction) (minerals).

  4. *Wisconsin Power & Light v. UP*, 5 S.T.B. 955 (2001), *modified,* STB Docket No. 42051 (May 14, 2002), *aff'd, Union Pacific R.R. v. STB*, No. 02-1198 (D.C. Cir. Apr. 30, 2003) — reparations & rate prescription (approx. 11% reduction).

  5. *Texas Municipal Power Agency v. Burlington N.&S.F.Ry.*, STB Docket No. 42056 (STB Mar. 24, 2003), *modified* (STB Sept. 27, 2004) — reparations & rate prescription (approx. 1-3% reduction).

  6. *Public Serv. Co. of Colo. d/b/a Xcel v. BNSF*, STB Docket No. 42057 (STB June 8, 2004), *modified* (STB Jan. 19, 2005), *aff'd sub nom. BNSF Ry. v. STB*, No. 05-1030 (D.C. Cir. June 16, 2006) — reparations (approx. $14 million) & rate prescription (approx. 16% reduction).

- **Shipper failed to show rate unreasonable:**

  1. *McCarty Farms, Inc. et al. v. Burlington N., Inc.*, 2 S.T.B. 460 (1997), *modified,* 3 S.T.B. 102 (1998), *aff'd, McCarty Farms, Inc. v. STB*, 158 F.3d 1294 (D. C. Cir. 1998) (grain).

  2. *PPL Montana, LLC v. Burlington N.&S.F.Ry.*, STB Docket No. 42054 (STB Aug. 20, 2002), *reaffirmed after reviewing supplemental evidence* (STB Aug. 31, 2004), *aff'd, PPL Montana, LLC v. STB*, No. 04-1369 (D.C. Cir. Feb. 17, 2006).

  3. *Duke Energy Corp. v. Norfolk Southern Ry.***,** STB Docket No. 42069 (STB Nov. 6, 2003), *modified* (STB Oct. 20, 2004), *dismissed based upon voluntary settlement* (STB July 8, 2005).

4. *Carolina Power & Light Co. v. Norfolk Southern Ry.*, STB Docket No. 42072 (STB Dec. 23, 2003), *modified* (STB Oct. 20, 2004), *dismissed based upon voluntary settlement* (STB July 8, 2005).

5. *Duke Energy Corp. v. CSX Transp. Inc.*, STB Docket No. 42070 (STB Feb. 4, 2004), *modified* (STB Oct. 20, 2004), *dismissed based upon voluntary settlement* (STB July 8, 2005).

6. *Arizona Elec. Power Coop., Inc. v. Burlington N.& S.F. Ry.*, STB Docket No. 42058 (STB Mar. 15, 2005), *pet. for judicial review pending, Arizona Elec. Power Coop., Inc. v. STB*, No. 05-1136 (D.C. Cir. filed Apr. 22, 2005).

7. *Otter Tail Power Co. v. BNSF Ry.*, STB Docket No. 42071 (STB Jan. 27, 2006), *modified* (STB May 26, 2006), *pets. for judicial review pending sub nom. Otter Tail Power Co. v. STB*, No. 06-1962 et al. (8th Cir. filed Apr. 10, 2006).