

GAO

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FREIGHT RAILROADS

Updated Information on Rates and Other Industry Trends

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Physical Infrastructure Issues





Highlights of [GAO-08-218T](#), a report to Subcommittee on Surface Transportation and Merchant Marine, Committee on Commerce, Science, and Transportation, U.S. Senate

Why GAO Did This Study

The Staggers Rail Act of 1980 largely deregulated the freight railroad industry, encouraging greater reliance on competition to set rates. The act recognized the need for railroads to recover costs by setting higher rates for shippers with fewer transportation alternatives but also recognized that some shippers might be subject to unreasonably high rates. It established a threshold for rate relief and granted the Interstate Commerce Commission and the Surface Transportation Board (STB) the authority to develop a rate relief process for “captive” shippers. Since 1980 GAO has issued several reports on the freight railroad industry and issued the most recent report in October 2006 and, at the request of this Subcommittee, issued an updated report in August 2007. This statement is based on these recent reports and discusses (1) recent changes that have occurred in railroad rates and how those changes compare to changes in rail rates since 1985, (2) the extent of captivity in the industry and STB’s efforts to protect captive shippers, and (3) STB’s actions to address GAO’s recent recommendations.

To view the full product, including the scope and methodology, click on [GAO-08-218T](#). For more information, contact JayEtta Z. Hecker at (202) 512-2834 or heckerj@gao.gov.

FREIGHT RAILROADS

Updated Information on Rates and Other Industry Trends

What GAO Found

While railroad rates have generally declined and declined for most shippers since 1985, in 2005 rates experienced a 9 percent annual increase over 2004—the largest annual increase in twenty years—and rates increased for all 13 commodities that GAO reviewed. For example, rates for coal increased by nearly 8 percent while rates for grain increased by 8.5 percent. However, despite these increases, rates for 2005 remain below their 1985 levels and below the rate of inflation over the 1985 through 2005 period. Revenues that railroads report as “miscellaneous”—a category that includes some fuel surcharges—increased more than ten-fold from about \$141 million in 2000 to over \$1.7 billion in 2005.

It is difficult to precisely determine how many shippers are “captive” because available proxy measures can overstate or understate captivity. However some data indicate that the extent of potentially captive traffic appears to have decreased, while at the same time, data also indicates that traffic traveling at rates significantly above the threshold for rate relief has increased. In October 2006, GAO reported that STB’s rate relief process to protect captive shippers have resulted in little effective relief for those shippers. GAO also reported that economists and shipper groups have proposed a number of alternatives to address remaining concerns about competition—however, each of these alternative approaches have costs and benefits and should be carefully considered.

STB has taken some actions to address our past recommendations, but it is too soon to determine the effect of these actions. Our October 2006 report noted that the continued existence of pockets of potentially “captive” shippers raised questions as to whether rail rates in selected markets reflected reasonable pricing practices, or an abuse of market power. GAO recommended that the Board undertake a rigorous analysis of competitive markets to identify the state of competition. STB has awarded a contract to conduct this study. It will be important that these analysts have STB’s authority and access to information to determine whether rail rates in selected markets reflect reasonable pricing practices—the Chairman of the STB recently testified that these analysts would have that authority and access. GAO also recommended that STB ensure that freight railroads are consistently reporting all revenues, including miscellaneous revenues. While STB has revised its rules on fuel surcharges, these rules did not address how fuel surcharges are reported and STB has not yet taken steps to accurately collect data on other miscellaneous revenues. STB has also taken a number of steps to revise its rate relief process. While these appear to be promising steps, it is too soon to tell what effect these changes will have.

Mr. Chairman and Members of the Subcommittee:

We appreciate the opportunity to testify on the freight railroad industry. As you know, over 25 years ago, Congress transformed federal regulation of the railroad industry. After almost 100 years of economic regulation, the railroad industry was in serious economic trouble in the 1970s, with rising costs, losses, and bankruptcies. In response, Congress passed the Railroad Revitalization and Regulatory Reform Act of 1976 and the Staggers Rail Act of 1980. Together, these pieces of legislation substantially deregulated the railroad industry. In particular, the 1980 act encouraged greater reliance on competition to set rates and gave railroads increased freedom to price their services according to market conditions, including the freedom to use differential pricing—that is, to recover a greater proportion of their costs from rates charged to shippers with a greater dependency on rail transportation. At the same time, the 1980 act anticipated that some shippers might not have competitive alternatives—commonly referred to as “captive” shippers—and gave the Interstate Commerce Commission (ICC), and later the Surface Transportation Board (STB), the authority to establish a process so that shippers could obtain relief from unreasonably high rates. However, only a rate that produces revenue equal to at least 180 percent of the variable cost of transporting the shipment can be challenged.

Policymakers continue to believe that the federal government should provide a viable process to protect shippers against unreasonably high rates, as well as address competition issues, while still balancing the interests of both railroads and shippers. Over the past 10 years, significant consolidation has taken place in the freight railroad industry, while railroads—particularly Class I railroads¹—have seen their productivity and financial health improve. Railroad officials express concern that any attempt to increase economic regulation will reduce carriers’ ability to earn sufficient revenues and limit future infrastructure investment.

Since the passage of the Staggers Rail Act in 1980, we have issued several reports on the freight railroad industry.² We issued our most recent report

¹As of 2004, a Class I railroad is any railroad with operating revenue above \$277.7 million.

²See GAO, *Freight Railroads: Industry Health Has Improved, but Concerns About Competition and Capacity Should Be Addressed*, [GAO-07-94](#) (Washington, D.C.: Oct. 6, 2006) and *Freight Railroads: Updated Information on Rates and Other Industry Trends*, [GAO-07-291R](#) (Washington, D.C.: Aug. 15, 2007). In addition, see the list of related GAO products at the end of this report.

in October 2006 and, at your request and the request of other members of this Subcommittee, issued an updated report in August 2007 to include 2005 data that was not yet available in October 2006. My comments today are based on those recent reports and will focus primarily on the updated information, including (1) recent changes that have occurred in railroad rates and how those changes compare to changes in rail rates since 1985, (2) the extent of captivity in the industry and STB's efforts to protect captive shippers, and (3) STB's actions to address our recent recommendations. We reviewed STB documents in September and October 2007 to update the information in our recent reports and conducted our review in accordance with generally accepted government auditing standards.

In summary:

- While railroad rates have generally declined and declined for most shippers since 1985, rates began to increase in 2001. In 2005 rates experienced a 9 percent annual increase over 2004³—the largest annual increase in twenty years—and rates increased for all 13 commodities that we reviewed. For example, rates for coal increased by nearly 8 percent while rates for grain increased by 8.5 percent. However, despite these increases, rates for 2005 remain below their 1985 levels and below the rate of inflation over the 1985 through 2005 period. In addition, over 20 years, railroad companies have shifted other costs to shippers, including railcar ownership. Revenues that railroads report as “miscellaneous revenue”—a category that includes some fuel surcharges—increased more than ten-fold from about \$141 million in 2000 to over \$1.7 billion in 2005. We have recommended that STB revise its data collection methods to more accurately collect data on railroad revenue.
- It is difficult to precisely determine how many shippers are “captive” because available proxy measures can overstate or understate captivity. However some data indicate that potentially captive traffic appears to have decreased, while at the same time, data also indicates that traffic traveling at rates significantly above the threshold for rate relief has increased. This trend continued in 2005 as tonnage and revenue from traffic traveling at rates above the statutory threshold for

³We constructed rate indexes to examine trends in rail rates over the 1985 to 2005 period. In our August 2007 report, we reported a 7 percentage point change in the rate index. Using 1.0 as our 1985 base we reported the change 0.8 to 0.87 from 2004-2005. This 7 percentage point change translates into an annual increase of 9 percent. In this testimony we refer to the annual increase and not the percentage change in the rate index.

rate relief declined, while a subset of this traffic representing traffic traveling at rates substantially above the threshold (greater than 300 percent of the variable cost of transporting the shipment), increased in 2005. This increase followed declines in 2003 and 2004 but continued a general upward trend since 1985. In October 2006, we reported that STB's efforts to protect captive shippers have resulted in little effective relief for those shippers. We also reported that economists and shipper groups have proposed a number of alternatives to address remaining concerns about competition and capacity – however, each of these alternative approaches have costs and benefits and should be carefully considered to ensure the approach will achieve the important balance set out in the Staggers Act of allowing the railroads to earn adequate revenues and invest in its infrastructure while assuring protection for captive shippers from unreasonable rates.

- STB has taken some actions to address our past recommendations, but it is too soon to determine the effect of these actions. Our October 2006 report noted that the continued existence of pockets of potentially “captive” shippers raised questions as to whether rail rates in selected markets reflected justified and reasonable pricing practices, or an abuse of market power by the railroads. Based on STB's statutory authority to adjudicate unreasonable rates and to inquire into and report on railroad practices, we recommended that the Board undertake a rigorous analysis of competitive markets to identify the state of competition nationwide and to determine in specific markets whether the inappropriate exercise of market power is occurring and, where appropriate, to consider the range of actions available to address such problems. STB has awarded a contract to conduct this study and we commend STB for taking this action. It will be important that these analysts have the ability that STB has through its statutory authority to inquire into railroad practices as well as sufficient access to information to determine whether rail rates in selected markets reflect justified and reasonable pricing practices or an abuse of market power by the railroads. The Chairman of the STB recently testified that these analysts would have that authority and access. We also recommended that STB ensure that all freight railroads are consistently and accurately reporting all revenues collected from shippers. While STB has revised its rules on establishing and collecting fuel surcharges, these rules did not address how surcharges are reported in the *Carload Waybill Sample* and STB has not yet taken steps to accurately collect data on other miscellaneous revenues. STB has also taken a number of steps to revise its rate relief process. While these appear to be positive steps, it

is too soon to tell what effect these changes will have and we have not evaluated the effect of these changes.

Background

In the past, the ICC regulated almost all of the rates that railroads charged shippers. The Railroad Revitalization and Regulatory Reform Act of 1976 and the Staggers Rail Act of 1980 greatly increased reliance on competition to set rates in the railroad industry. Specifically, these acts allowed railroads and shippers to enter into confidential contracts that set rates and prohibited ICC from regulating rates where railroads had either effective competition or rates negotiated between the railroad and the shipper. Furthermore, the ICC Termination Act of 1995 abolished ICC and transferred its regulatory functions to STB. Taken together, these acts anchor the federal government's role in the freight rail industry by establishing numerous goals for regulating the industry, including to

- allow, to the maximum extent possible, competition and demand for services to establish reasonable rates for transportation by rail;
- minimize the need for federal regulatory control over the rail transportation system and require fair and expeditious regulatory decisions when regulation is required;
- promote a safe and efficient rail transportation system by allowing rail carriers to earn adequate revenues, as determined by STB;
- ensure the development and continuation of a sound rail transportation system with effective competition among rail carriers and with other modes to meet the needs of the public and the national defense;
- foster sound economic conditions in transportation and ensure effective competition and coordination between rail carriers and other modes;
- maintain reasonable rates where there is an absence of effective competition and where rail rates provide revenues that exceed the amount necessary to maintain the rail system and attract capital;
- prohibit predatory pricing and practices to avoid undue concentrations of market power; and
- provide for the expeditious handling and resolution of all proceedings.

While the Staggers Rail and ICC Termination Acts reduced regulation in the railroad industry, they maintained STB's role as the economic regulator of the industry. The federal courts have upheld STB's general powers to monitor the rail industry, including its ability to subpoena witnesses and records and to depose witnesses. In addition, STB can revisit its past decisions if it discovers a material error, or new evidence, or if circumstances have substantially changed.

Two important components of the current regulatory structure for the railroad industry are the concepts of revenue adequacy and demand-based differential pricing. Congress established the concept of revenue adequacy as an indicator of the financial health of the industry. STB determines the revenue adequacy of a railroad by comparing the railroad's return on investment with the industrywide cost of capital. For instance, if a railroad's return on investment is greater than the industrywide cost of capital, STB determines that railroad to be revenue adequate. Historically, ICC and STB have rarely found railroads to be revenue adequate—a result that many observers relate to characteristics of the industry's cost structure. Railroads incur large fixed costs to build and operate networks that jointly serve many different shippers. Some fixed costs can be attributed to serving particular shippers, and some costs vary with particular movements, but other costs are not attributable to particular shippers or movements. Nonetheless, a railroad must recover these costs if the railroad is to continue to provide service over the long run. To the extent that railroads have not been revenue adequate, they may not have been fully recovering these costs.

The Staggers Rail Act recognized the need for railroads to use demand-based differential pricing to promote a healthy rail industry and enable it to raise sufficient revenues to operate, maintain and, if necessary, expand the system in a deregulated environment. Demand-based differential pricing, in theory, permits a railroad to recover its joint and common costs—those costs that exist no matter how many shipments are transported, such as the cost of maintaining track—across its entire traffic base by setting higher rates for traffic with fewer transportation alternatives than for traffic with more alternatives. Differential pricing recognizes that some customers may use rail if rates are low—and have other options if rail rates are too high or service is poor. Therefore, rail rates on these shipments generally cover the directly attributable (variable) costs, plus a relatively low contribution to fixed costs. In contrast, customers with little or no practical alternative to rail—“captive” shippers—generally pay a much larger portion of fixed costs. Moreover, even though a railroad might incur similar incremental costs while providing service to two different shippers that move similar volumes in similar car types traveling over similar distances, the railroad might charge the shippers different rates. Furthermore, if the railroad is able to offer lower rates to the shipper with more transportation alternatives, that shipper still pays some of the joint and common costs. By paying even a small part of total fixed cost, competitive traffic reduces the share of those costs that captive shippers would have to pay if the competitive traffic switched to truck or some other alternative. Consequently, while the

shipper with fewer alternatives makes a greater contribution toward the railroad's joint and common costs, the contribution is less than if the shipper with more alternatives did not ship via rail.

The Staggers Rail Act further requires that the railroads' need to obtain adequate revenues to be balanced with the rights of shippers to be free from, and to seek redress from, unreasonable rates. Railroads incur variable costs—that is, the costs of moving particular shipments—in providing service. The Staggers Rail Act stated that any rate that was found to be below 180 percent of a railroad's variable cost for a particular shipment could not be challenged as unreasonable and authorized ICC, and later STB, to establish a rate relief process for shippers to challenge the reasonableness of a rate. STB may consider the reasonableness of a rate only if it finds that the carrier has market dominance over the traffic at issue—that is, if (1) the railroad's revenue is equal to or above 180 percent of the railroad's variable cost (R/VC) and (2) the railroad does not face effective competition from other rail carriers or other modes of transportation.

Rail Rates Have Increased Recently But Have Generally Declined Since 1985, While Railroads Have Shifted Other Costs To Shippers

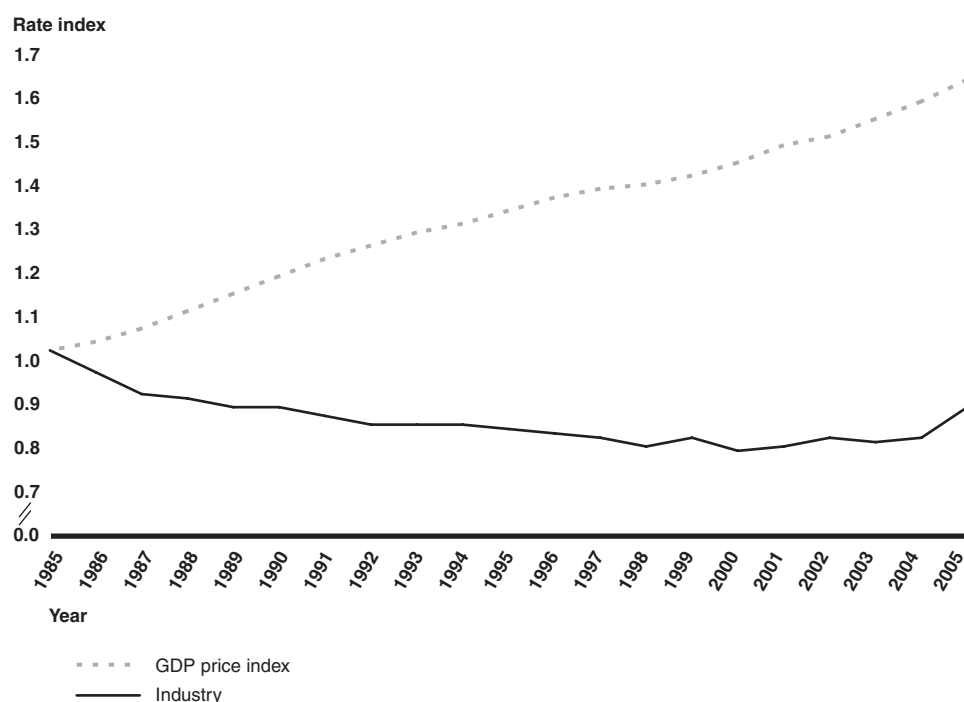
Rail rates have generally declined since 1985, but experienced a 9 percent annual increase between 2004 and 2005—the largest annual increase in 20 years. Although rates have generally declined, railroads have also shifted other costs to shippers, such as the cost of rail car ownership, and have increased the revenue they report as miscellaneous more than 10-fold between 2000 and 2005.

Rail Rates Have Recently Increased But Generally Declined Since 1985

Following a period of general decline since 1985, rates began to increase in 2001. Rates experienced a 9 percent annual increase from 2004-2005, which represents the largest annual increase in rates during the 20-year period from 1985 through 2005. This annual increase also outpaced inflation—about 3 percent in 2005. However, despite these increases, rates for 2005 remain below their 1985 levels and below the rate of inflation for

the 1985 through 2005 period, and rates overall have declined since 1985⁴. Because the set of rail rate indexes we used to examine trends in rail rates over time does not account for inflation we also included the price index for the gross domestic product (GDP) in figure 1.

Figure 1: Trends in Industry Rail Rates, 1985-2005



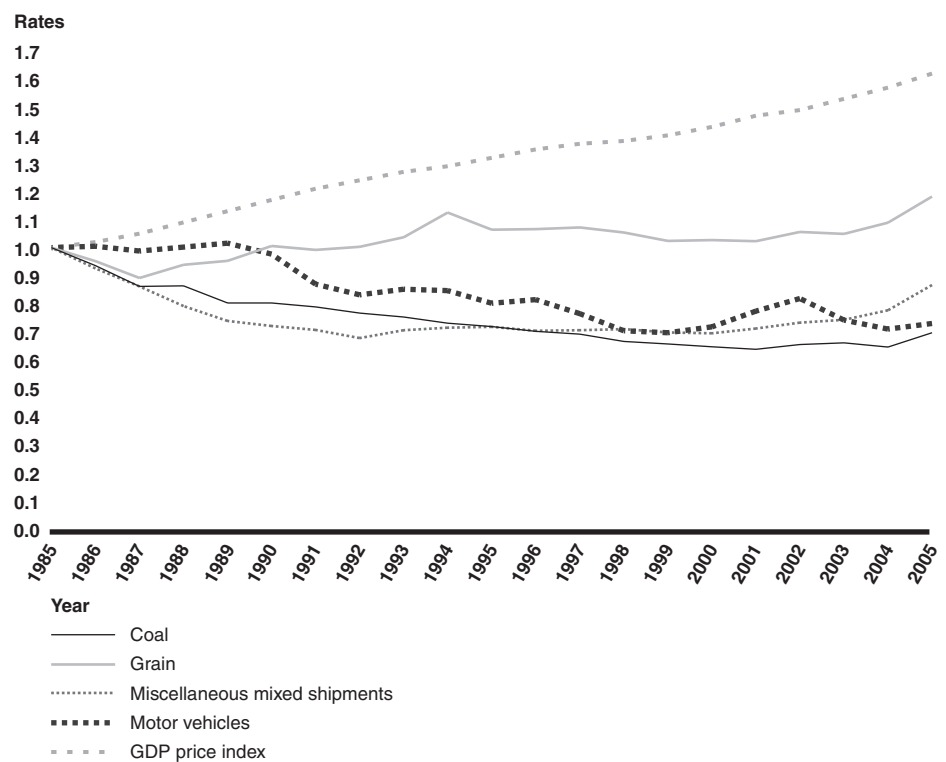
Source: GAO analysis of STB data.

⁴We constructed rate indexes to examine trends in rail rates over the 1985 to 2005 period. These indexes define traffic patterns for a given commodity in terms of census region to census region flows of that commodity, and we calculated the average revenue per ton-mile for each of these traffic flows. The index is calculated as the weighted average of these traffic flows in each year, expressed as a percentage of the value for 1985, where the weights reflect the traffic patterns in 2005. By fixing the weights as of one period of time, we attempted to measure pure price changes rather than calculating the average revenue per ton-mile in each year. Over time, changes in traffic patterns could result in a substitution of lower priced traffic for higher priced traffic, or vice versa, so that a decrease in average revenue per ton-mile might partly reflect this change in traffic patterns. The rate index for the overall industry was defined similarly, except that the traffic pattern bundle was defined in terms of broad commodity, census region of origin, and mileage block categories. For comparison, we also present the price index for gross domestic product over this period.

While Generally Declining over the Long Term, Rates for Several Commodities Have Recently Increased

Similar to overall industry trends, rates for individual commodities have increased from 2004-2005. In 2005, rates increased for all 13 commodities that we reviewed. Rates for coal increased by 7.9 percent while rates for grain increased by 8.5 percent. In 2005, the largest rate increase (for fireboard and paperboard) exceeded 11 percent, while the smallest increase (for motor vehicles) was about 2.7 percent. Figure 2 depicts rate changes for coal, grain, miscellaneous mixed shipments, and motor vehicles from 1985 through 2005.

Figure 2: Rate Changes for Coal, Grain, Miscellaneous Mixed Shipments, and Motor Vehicles, 1985-2005



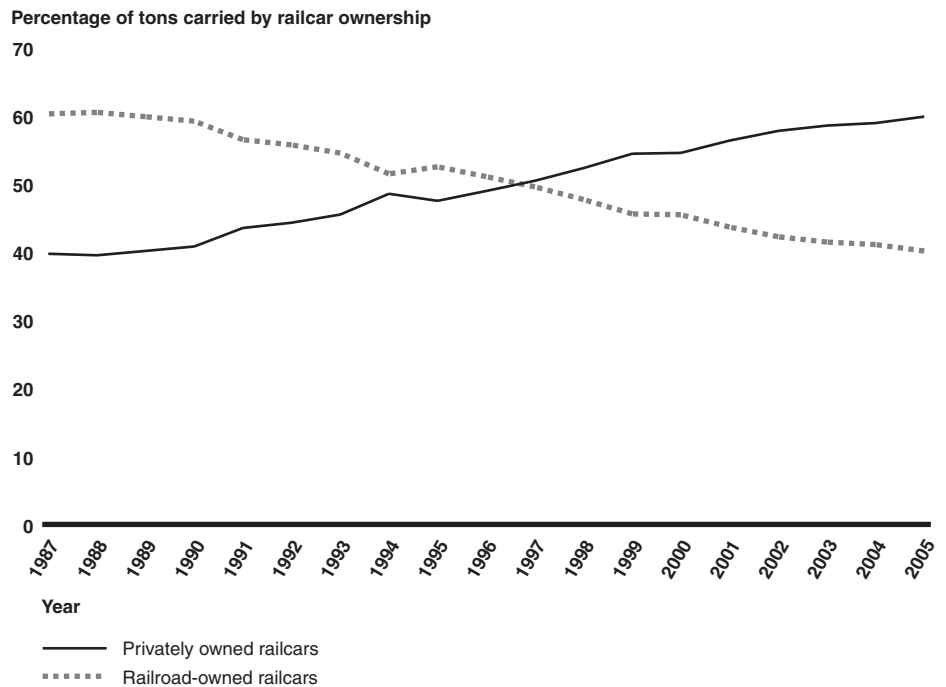
Source: GAO analysis of STB data.

Railroads Have Shifted Costs to Shippers

In 2005, freight railroad companies continued a trend of shifting other costs to shippers. Our analysis shows a 20 percentage point increase shift in railcar ownership (measured in tons carried) since 1987. In 1987, railcars owned by freight railroad companies moved 60 percent of tons carried. In 2005, they moved 40 percent of tons carried, meaning that

freight railroad company railcars no longer carry the majority of tonnage (see fig. 3).

Figure 3: Tonnage Carried by Railcar Ownership, 1987-2005



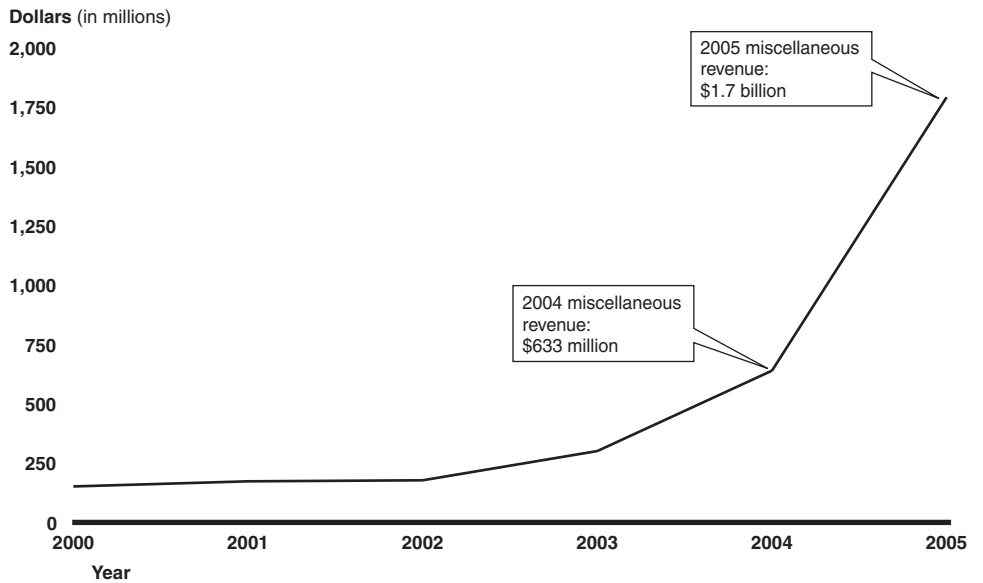
Source: GAO analysis of STB data.

Reported Miscellaneous Revenue, Including Fuel Surcharges, Increased Ten-Fold Since 2000

In 2005 the amount of industry revenue reported as miscellaneous increased ten-fold over 2000 levels, rising from about \$141 million to over \$1.7 billion (see fig. 4). Miscellaneous revenue is a category in the Carload Waybill Sample for reporting revenue outside the standard rate structure. This miscellaneous revenue can include some fuel surcharges,⁵ as well as revenues such as those derived from congestion fees and railcar auctions (in which the highest bidder is guaranteed a number of railcars at a specified date). In 2004, miscellaneous revenue accounted for 1.5 percent of freight railroad revenue reported. In 2005, this percentage had risen to 3.7 percent. Also, in 2005, 20 percent of all tonnage moved in the United States generated miscellaneous revenue.

⁵Fuel surcharges are charges associated with recouping the cost of fuel.

Figure 4: Miscellaneous Revenue Tracked in Carload Waybill Sample, 2000-2005



Source: GAO analysis of STB data.

Captive Shippers Are Difficult to Identify But Concerns Remain and Past STB Actions Have Led to Little Effective Relief

In October 2006 and August 2007, we reported that captive shippers are difficult to identify and STB’s efforts to protect captive shippers have resulted in little effective relief for those shippers. We also reported that economists and shipper groups have proposed a number of alternatives to address remaining concerns about competition – however, each of these alternative approaches have costs and benefits and should be carefully considered to ensure the approach will achieve the important balance set out in the Staggers Act.

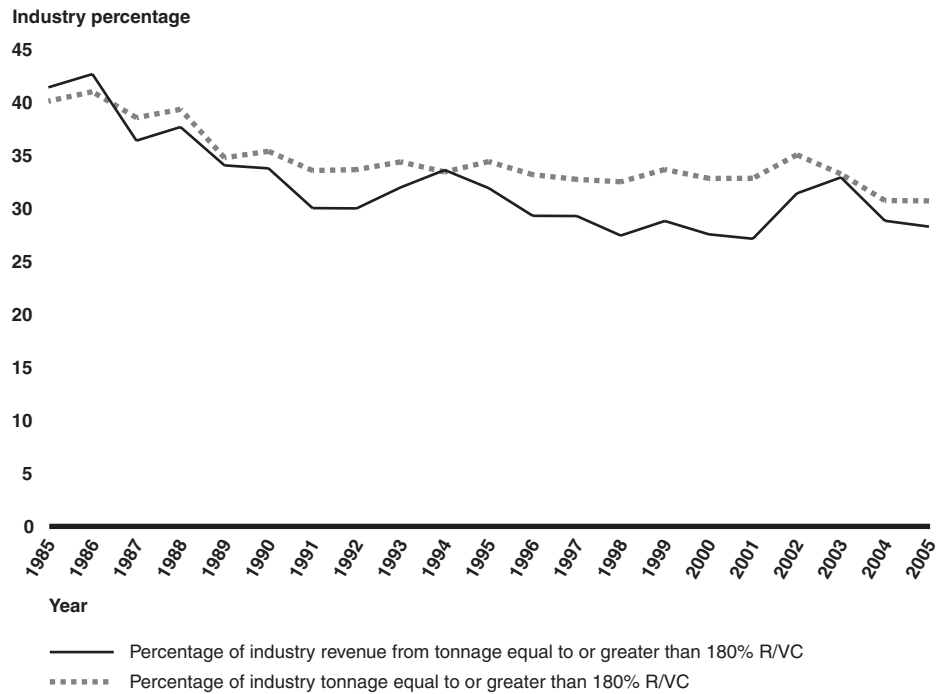
Captive Shippers Remain Difficult to Identify, but Some Measures Indicate Captivity Is Dropping in the Railroad Industry

It remains difficult to determine precisely how many shippers are “captive” to one railroad because the proxy measures that provide the best indication can overstate or understate captivity. One measure of potential captivity—traffic traveling at rates equal to or greater than 180 percent R/VC—is part of the statutory threshold for bringing a rate relief case before STB.⁶ STB regards traffic at or above this threshold as “potentially captive,” but, like other measures, R/VC levels can understate or overstate captivity.⁷ Since 1985, tonnage and revenue from traffic traveling at rates over 180 percent R/VC have generally declined, while traffic traveling at rates substantially over the threshold for rate relief (greater than 300 percent R/VC) has generally increased. This trend continued in 2005, as industry revenue generated by traffic traveling at rates over 180 percent R/VC dropped by roughly half a percent. Tonnage traveling at rates over 180 percent R/VC dropped by a smaller percentage.

⁶Another condition of bringing a rate relief case before STB is a railroad not facing effective competition from other rail carriers or other modes of transportation.

⁷For example, it is possible for the R/VC ratio to increase while the rate paid by a shipper is declining. Assume that in Year 1, a shipper is paying a rate of \$20 and the railroad’s variable cost is \$12; the R/VC ratio—a division of the rate and the variable cost—would be 167 percent. If in Year 2, the variable costs decline by \$2 from \$12 to \$10 and the railroad passes this cost savings directly on to the shipper in the form of a reduced rate, the shipper would pay \$18 instead of \$20. However, because both revenue and variable cost decline, the R/VC ratio—\$18 divided by \$10—increases to 180 percent.

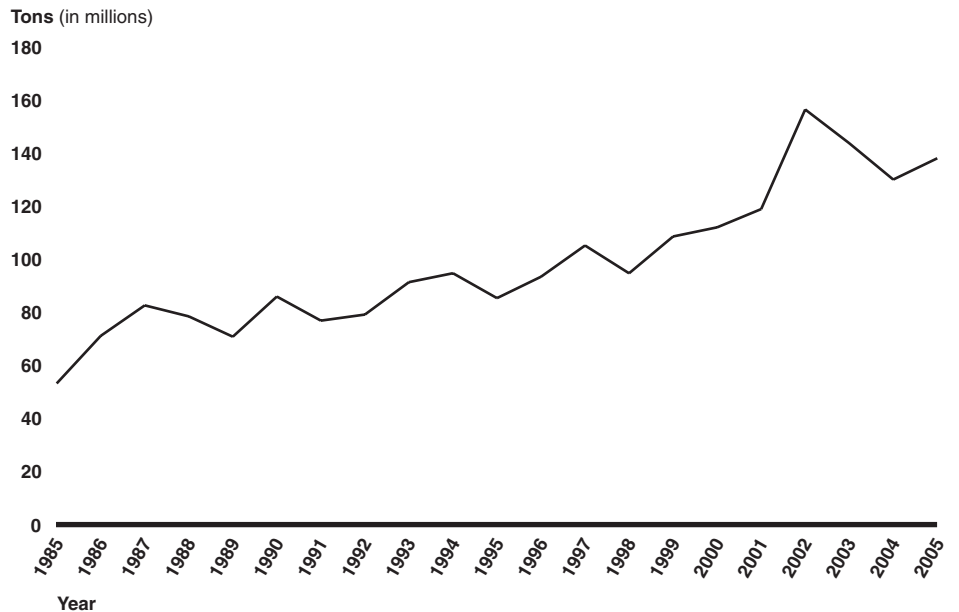
Figure 5: Tonnage and revenue generated from Traffic Traveling at Rates Equal to or Greater Than 180 percent R/VC, 1985-2005



Source: GAO analysis of STB data.

Traffic traveling at rates substantially over the threshold for rate relief has generally increased from 1985 to 2005 (see fig. 6). In 2003 and 2004, the percentage of both tonnage and revenue traveling at rates above 300 percent R/VC declined from the previous year, but each increased again in 2005. For example, the share of tonnage traveling at rates over 300 percent R/VC increased from 6.1 percent in 2004 to 6.4 percent in 2005. Figure 6 shows tonnage traveling at rates above 300 percent R/VC from 1985 through 2005.

Figure 6: Tonnage Traveling at Rates over 300 Percent R/VC, 1985-2005



Source: GAO analysis of STB data.

Some areas with access to one Class I railroad also have more than half of their traffic traveling at rates that exceed the statutory threshold for rate relief. For example, parts of New Mexico and Idaho with access to one Class I railroad had more than half of all traffic originating in those same areas traveling at rates over 180 percent R/VC. However, we also found instances in which an economic area may have access to two or more Class I railroads and still have more than 75 percent of its traffic traveling at rates over 180 percent R/VC, as well as other instances in which an economic area may have access to one Class I railroad and have less than 25 percent of its traffic traveling at rates over 180 percent R/VC.

STB Has Taken Actions to Protect Captive Shippers but Efforts Have Led to Little Effective Relief

STB has taken a number of actions to provide relief for captive shippers. While the Staggers Rail and ICC Termination Acts encourage competition as the preferred way to protect shippers and to promote the financial health of the railroad industry, they also give STB the authority to

- *adjudicate rate cases* to resolve disputes between captive shippers and railroads upon receiving a complaint from a shipper;

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- *approve rail transactions*, such as mergers, consolidations, acquisitions, and trackage rights;
 - *prescribe new regulations*, such as rules for competitive access and merger approvals; and
 - *inquire into and report on rail industry practices*, including obtaining information from railroads on its own initiative and holding hearings to inquire into areas of concern, such as competition.

Under its adjudicatory authority, STB has developed standard rate case guidelines, under which captive shippers can challenge a rail rate and appeal to STB for rate relief. Under the standard rate relief process, STB assesses whether the railroad dominates the shipper's transportation market and, if it finds market dominance, proceeds with further assessments to determine whether the actual rate the railroad charges the shipper is reasonable. STB requires that the shipper demonstrate how much an optimally efficient railroad would need to charge the shipper and construct a hypothetical, perfectly efficient railroad that would replace the shipper's current carrier. As part of the rate relief process, both the railroad and the shipper have the opportunity to present their facts and views to STB, as well as to present new evidence.

STB also created alternatives to the standard rate relief process, developing simplified guidelines, as Congress required, for cases in which the standard rate guidelines would be too costly or infeasible given the value of the cases. Under these simplified guidelines, captive shippers who believe that their rate is unreasonable can appeal to STB for rate relief, even if the value of the disputed traffic makes it too costly or infeasible to apply the standard guidelines.

Despite STB's efforts, we reported in 2006 that there was widespread agreement that STB's standard rate relief process was inaccessible to most shippers and did not provide for expeditious handling and resolution of complaints. The process remained expensive, time consuming, and complex. Specifically, shippers we interviewed agreed that the process could cost approximately \$3 million per litigant. In addition, shippers said that they do not use the process because it takes so long for STB to reach a decision. Lastly, shippers stated that the process is both time consuming and difficult because it calls for them to develop a hypothetical competing railroad to show what the rate should be and to demonstrate that the existing rate is unreasonable.

We also reported that the simplified guidelines also had not effectively provided relief for captive shippers. Although these simplified guidelines

had been in place since 1997, a rate case had not been decided under the process set out by the guidelines when we issued our report in 2006. STB had held public hearings in April 2003 and July 2004 to examine why shippers have not used the guidelines and to explore ways to improve them. At these hearings, numerous organizations provided comments to STB on measures that could clarify the simplified guidelines, but no action was taken. STB observed that parties urged changes to make the process more workable, but disagreed on what those changes should be. We reported that several shipper organizations told us that shippers were concerned about using the simplified guidelines because they believe the guidelines will be challenged in court, resulting in lengthy litigation. STB officials told us that they—not the shippers—would be responsible for defending the guidelines in court. STB officials also said that if a shipper won a small rate case, STB could order reparations to the shipper before the case was appealed to the courts.

Since our report in October 2006, STB has taken steps to refine the rate relief process. Specifically, in October 2006, STB revised procedures for deciding large rate relief cases. By placing restraints on the evidence and arguments allowed in these cases, STB predicted that the expense and delay in resolving these rate disputes would be reduced substantially. In September 2007, STB altered its simplified guidelines for small shippers to enable shippers who are seeking up to \$1 million in rate relief over a 5-year period to receive a STB decision within 8 months of filing a complaint. STB also created a new rate relief process for medium size shipments to allow shippers who are seeking up to \$5 million in rate relief over a 5-year period to receive a STB decision within 17 months of filing a complaint. Additionally, STB also stated that all rail rate disputes would require nonbinding mediation.

**Shipper Groups and Others
Have Suggested
Alternative Approaches
That Have Costs and
Benefits**

Shipper groups, economists, and other experts in the rail industry have suggested several alternative approaches as remedies that could provide more competitive options to shippers in areas of inadequate competition or excessive market power. These groups view these approaches as more effective than the rate relief process in promoting a greater reliance on competition to protect shippers against unreasonable rates. Some

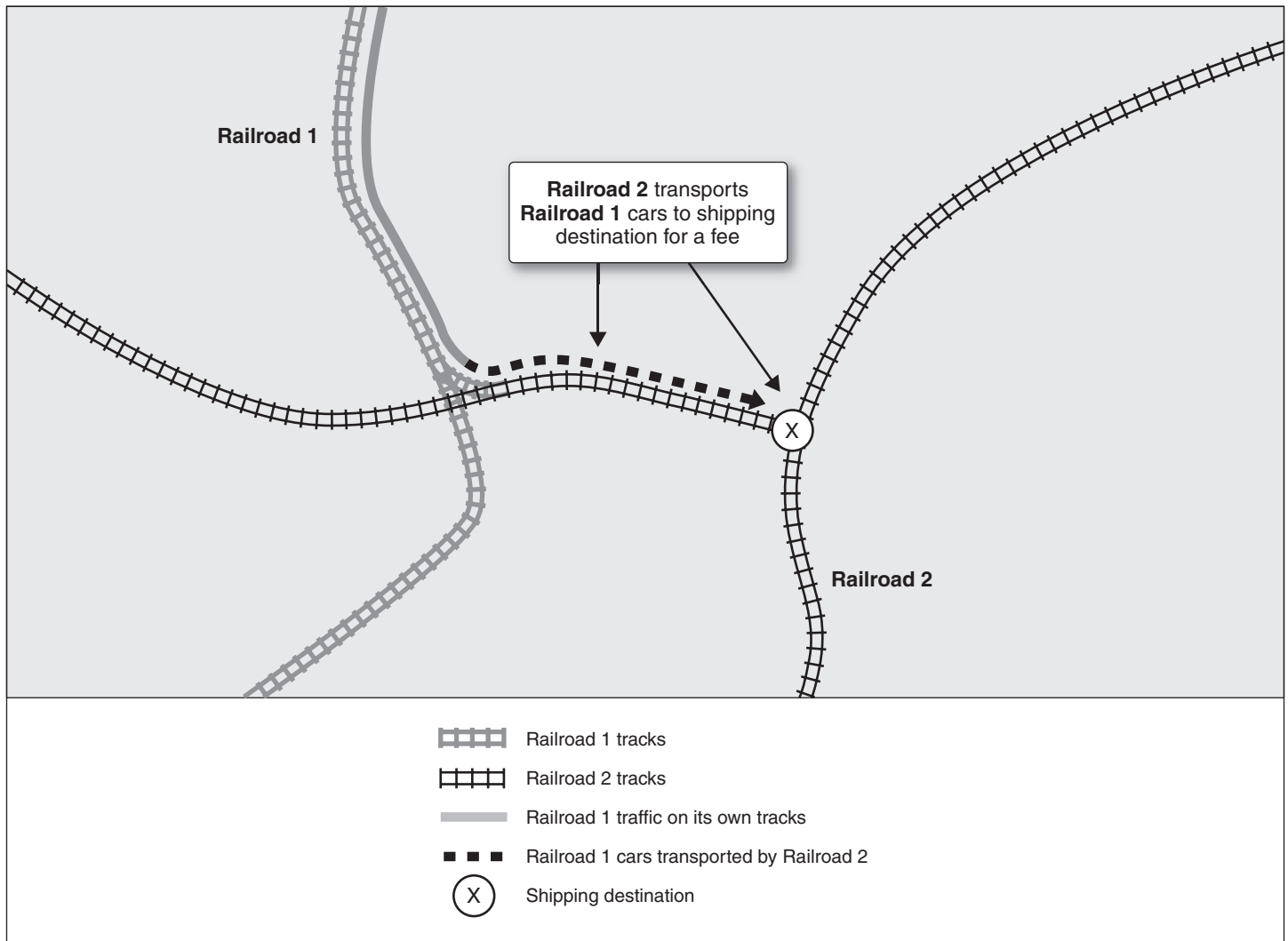
proposals would require legislative change, or a reopening of past STB decisions.⁸

These approaches each have potential costs and benefits. On the one hand, they could expand competitive options, reduce rail rates, and decrease the number of captive shippers as well as reduce the need for both federal regulation and a rate relief process. On the other hand, reductions in rail rates could affect railroad revenues and limit the railroads' ability and potential willingness to invest in their infrastructure. In addition, some markets may not have the level of demand needed to support competition among railroads. It will be important for policymakers, in evaluating these alternative approaches, to carefully consider the impact of each approach on the balance set out in the Staggers Act. The targeted approaches frequently proposed by shipper groups and others include the following:

- *Reciprocal switching*: This approach would allow STB to require railroads serving shippers that are close to another railroad to transport cars of a competing railroad for a fee. The shippers would then have access to railroads that do not reach their facilities. This approach is similar to the mandatory interswitching in Canada, which enables a shipper to request a second railroad's service if that second railroad is within approximately 18 miles. Some Class I railroads already interchange traffic using these agreements, but they oppose being required to do so. Under this approach, STB would oversee the pricing of switching agreements. This approach could also reduce the number of captive shippers by providing a competitive option to shippers with access to a proximate but previously inaccessible railroad and thereby reduce traffic eligible for the rate relief process (see fig. 7).

⁸Another proposal, articulated by economists Curtis Grimm and Cliff Winston, calls for the elimination of STB. This proposal recognizes that captive shippers have likely been hurt by a lack of competition, but it states that allowing the Department of Justice to review rail mergers instead of STB and ending the potential for reregulation of the industry could lead railroad officials and shippers to negotiate an agreement to address remaining rail competition concerns. Curtis Grimm and Clifford Winston, "Competition in the Deregulated Railroad Industry: Sources, Effects, and Policy Issues," (AEI – Brookings Institution. Washington, D.C.: 2000).

Figure 7: Reciprocal Switching

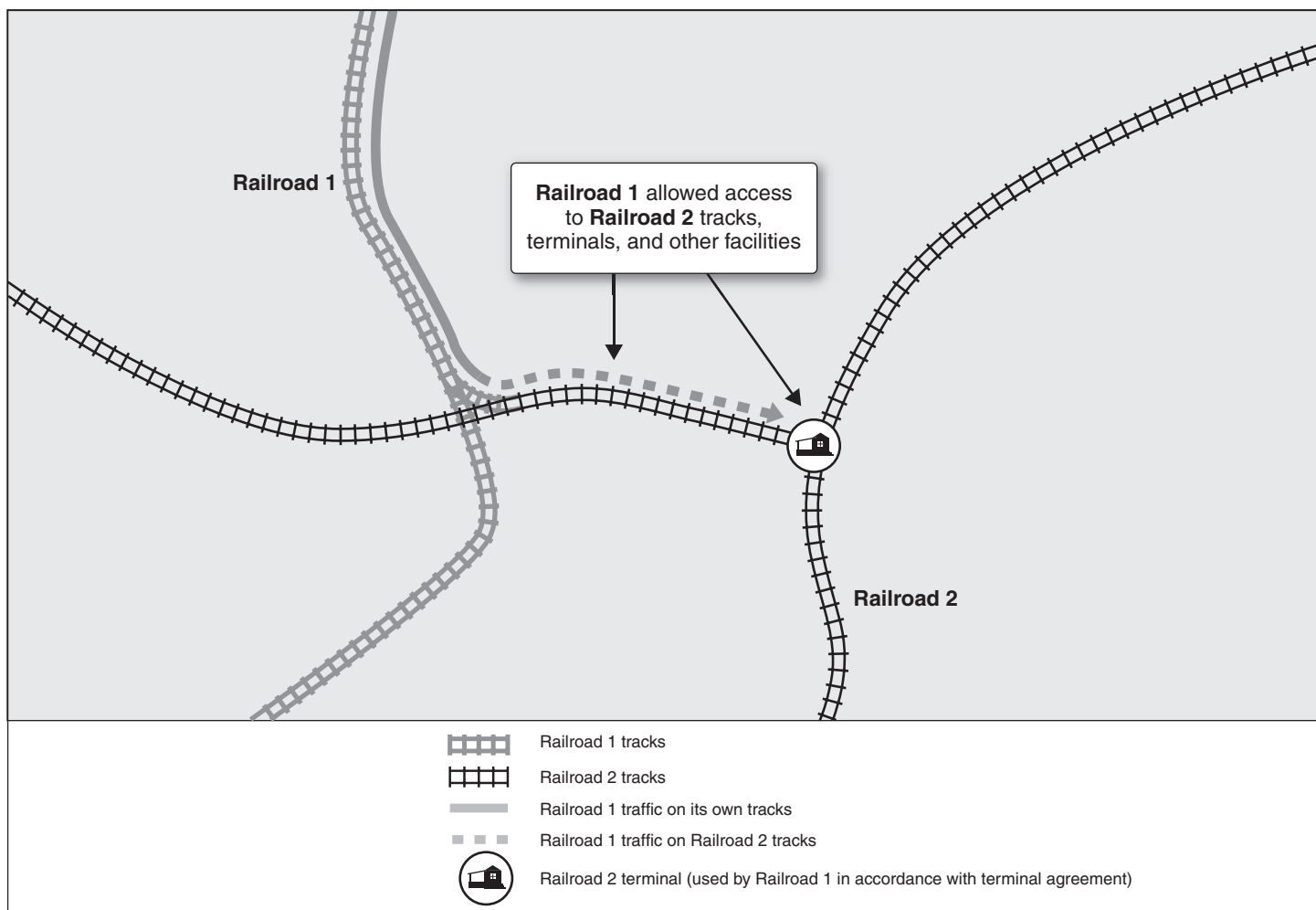


Source: GAO.

- *Terminal agreements:* This approach would require one railroad to grant access to its terminal facilities or tracks to another railroad, enabling both railroads to interchange traffic or gain access to traffic coming from shippers off the other railroad's lines for a fee. Current regulation requires a shipper to demonstrate anticompetitive conduct by a railroad before STB will grant access to a terminal by a nonowning railroad unless there is an emergency or when a shipper can demonstrate poor service and a second railroad is willing and able to

provide the service requested. This approach would require revisiting the current requirement that railroads or shippers demonstrate anticompetitive conduct in making a case to gain access to a railroad terminal in areas where there is inadequate competition. The approach would also make it easier for competing railroads to gain access to the terminal areas of other railroads and could increase competition between railroads. However, it could also reduce revenues to all railroads involved and adversely affect the financial condition of the rail industry. Also, shippers could benefit from increased competition but might see service decline (see fig. 8).

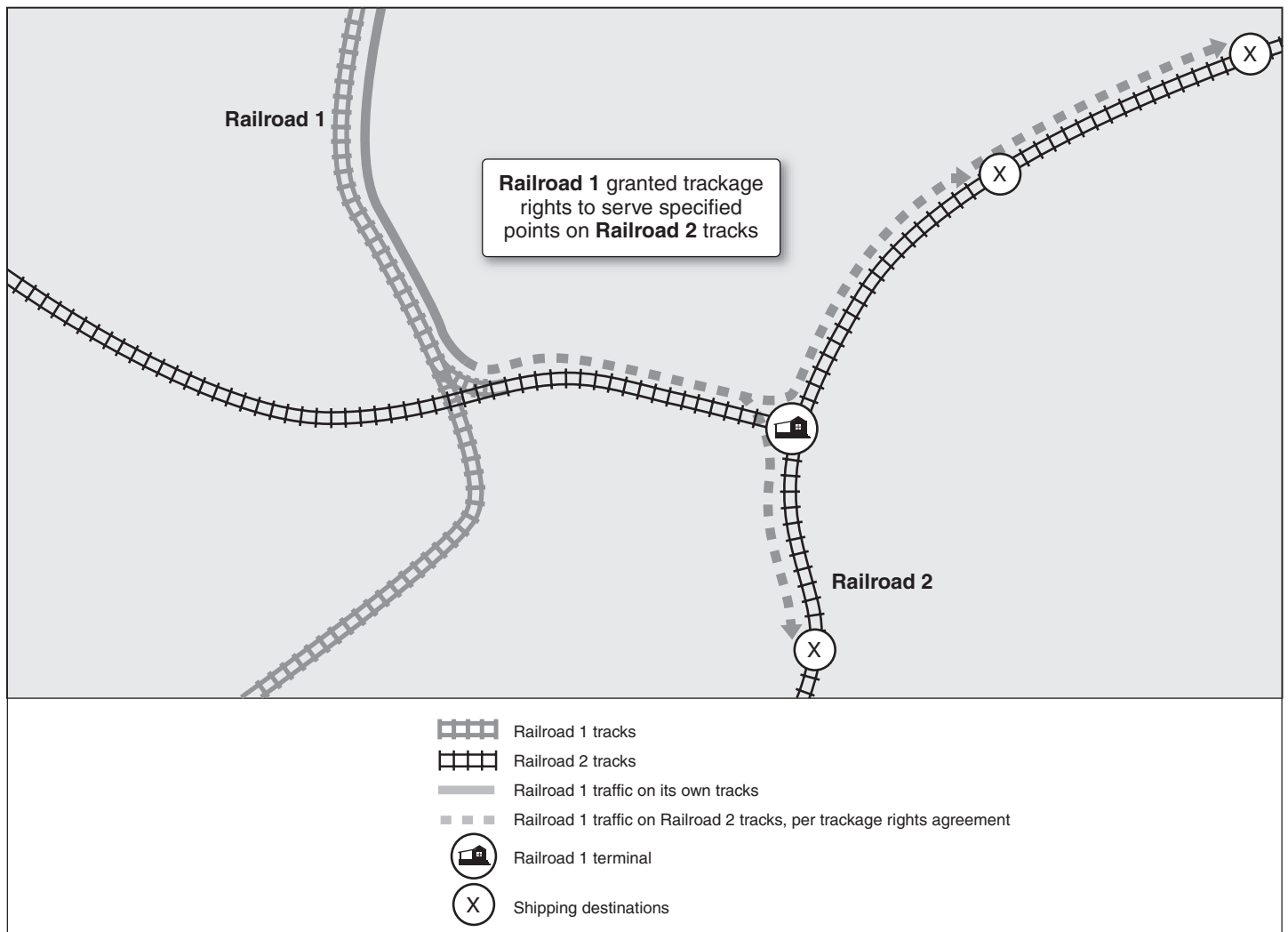
Figure 8: Terminal Agreements



Source: GAO.

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- *Trackage rights:* This approach would require one railroad to grant access to its tracks to another railroad, enabling railroads to interchange traffic beyond terminal facilities for a fee. In the past, STB has imposed conditions requiring that a merging railroad must grant another railroad trackage rights to preserve competition when a merger would reduce a shipper's access to railroads from two to one. While this approach could potentially increase rail competition and decrease rail rates, it could also discourage owning railroads from maintaining the track or providing high-quality service, since the value of lost use of track may not be compensated by the user fee and may decrease return on investment (see fig. 9).

Figure 9: Trackage Rights



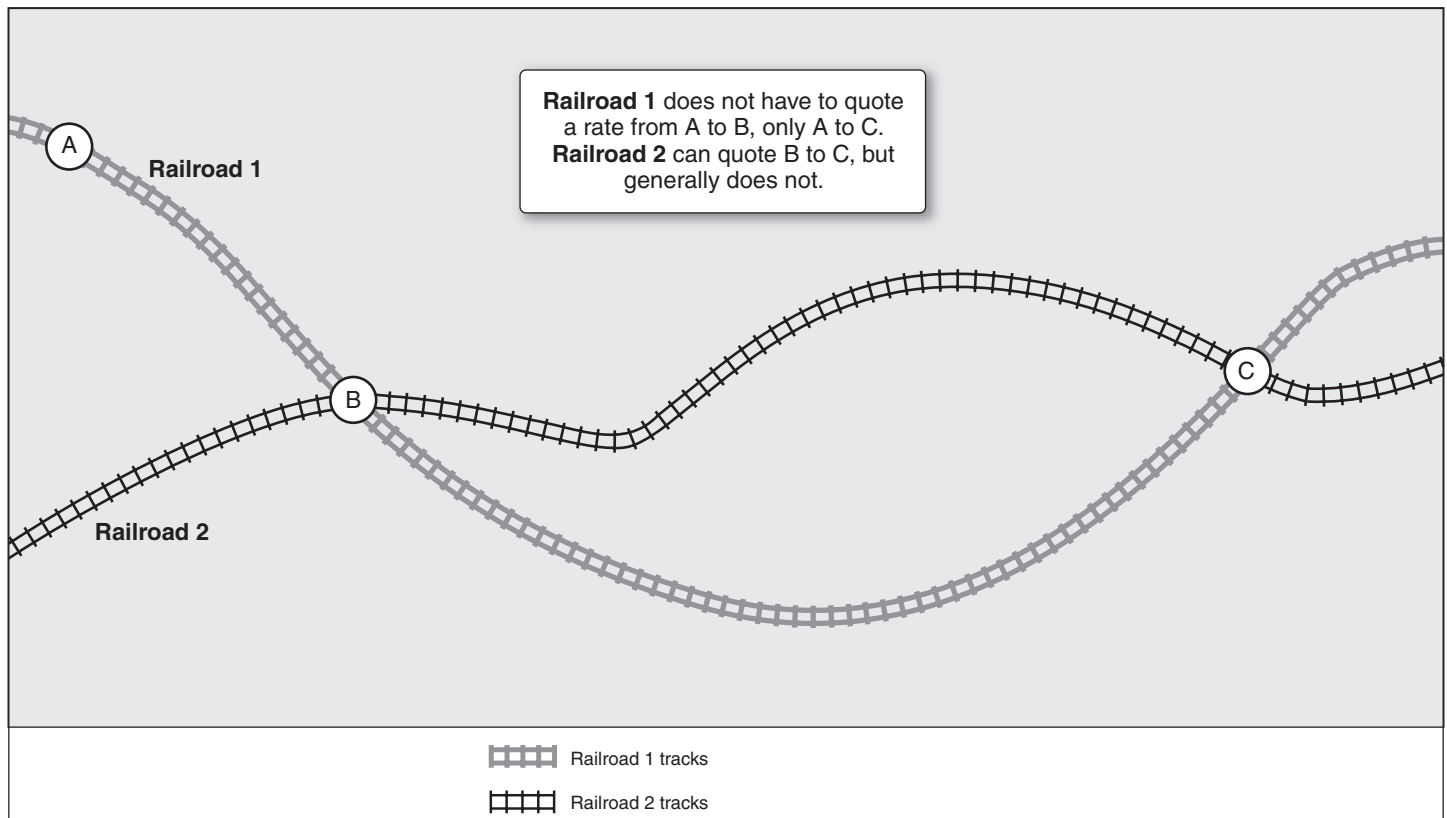
Source: GAO.

- **“Bottleneck” rates:** This approach would require a railroad to establish a rate, and thereby offer to provide service, for any two points on the railroad’s system where traffic originates, terminates, or can be interchanged. Some shippers have more than one railroad that serves them at their origin and/or destination points, but have at least one portion of a rail movement for which no alternative rail route is available. This portion

is referred to as the “bottleneck segment.” STB’s decision that a railroad is not required to quote a rate for the bottleneck segment has been upheld in federal court.⁹ STB’s rationale was that statute and case law precluded it from requiring a railroad to provide service on a portion of its route when the railroad serves both the origin and destination points and provides a rate for such movement. STB requires a railroad to provide service for the bottleneck segment only if the shipper had prior arrangements or a contract for the remaining portion of the shipment route. On the one hand, requiring railroads to establish bottleneck rates would force short-distance routes on railroads when they served an entire route and could result in loss of business and potentially subject the bottleneck segment to a rate complaint. On the other hand, this approach would give shippers access to a second railroad, even if a single railroad was the only railroad that served the shipper at its origin and/or destination points, and could potentially reduce rates (see fig. 10).

⁹The U.S. Court of Appeals for the Eighth Circuit affirmed STB decision that a bottleneck carrier generally need not quote a separate rate for the bottleneck portion of the route. *Mid-American Energy Co. v. Surface Transportation Board*, 169 F. 3d 1099 (8th Cir.: Feb. 10, 1999). The D.C. Circuit affirmed STB holding that separately challengeable bottleneck rates can be required whenever a shipper has a contract over the nonbottleneck segment of a through movement. *Union Pacific Railroad v. Surface Transportation Board*, 202 F. 3d 337 (D.C. Cir.: 2000).

Figure 10: Bottleneck Rates

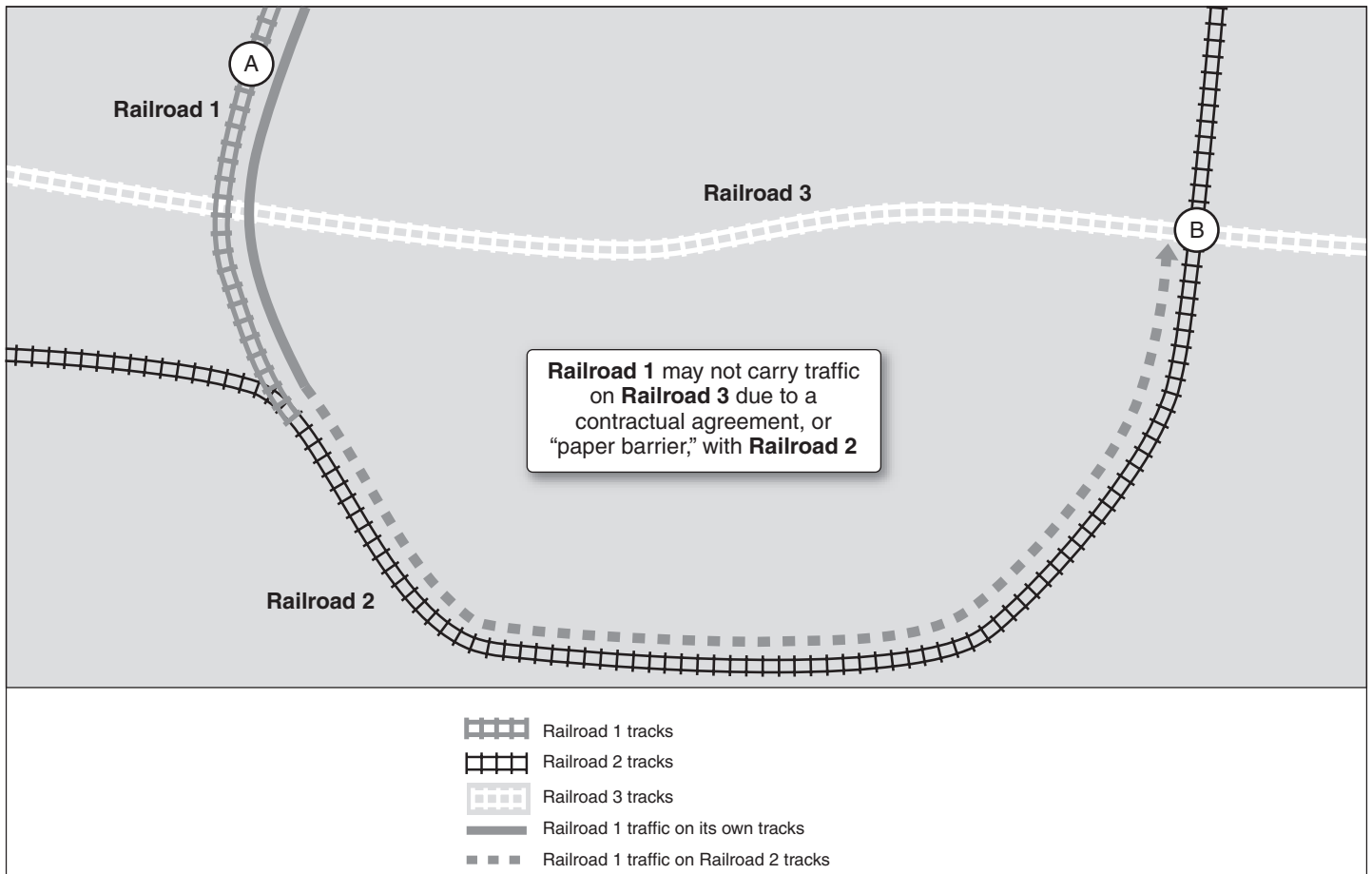


Source: GAO.

- *Paper barriers*: This approach would prevent or, put a time limit on, paper barriers, which are contractual agreements that can occur when a Class I railroad either sells or leases long term some of its track to other railroads (typically a short-line railroad and/or regional railroad). These agreements stipulate that virtually all traffic that originates on that line must interchange with the Class I railroad that originally leased the tracks or pay a penalty. Since the 1980s, approximately 500 short lines have been created by Class I railroads selling a portion of their lines; however, the extent to which paper barriers are a standard practice is unknown because they are part of confidential contracts. When this type of agreement exists, it can inhibit smaller railroads that connect with or cross two or more Class I rail systems from providing rail customers access to competitive service. Eliminating paper barriers could affect the railroad industry's overall capacity since Class I railroads may abandon lines instead of selling them to smaller railroads and thereby increase the cost of entering a market for a would-be competitor. In addition, an official from a railroad

association told us that it is unclear if a federal agency could invalidate privately negotiated contracts (see fig. 11).

Figure 11: Paper Barriers



Source: GAO.

STB Has Taken Steps to Address Problems, but Actions Are Too Recent to Be Evaluated

STB has taken some actions to address our past recommendations, but it is too soon to determine the effect of these actions. In October 2006 we reported that the continued existence of pockets of potential captivity at a time when the railroads are, for the first time in decades, experiencing increasing economic health, raises the question whether rail rates in selected markets reflect justified and reasonable pricing practices, or an abuse of market power by the railroads. While our analysis provided an important first step, we noted that STB has the statutory authority and access to information to inquire into and report on railroad practices and to conduct a more rigorous analysis of competition in the freight rail industry. As a result, we recommended that the Board undertake a rigorous analysis of competitive markets to identify the state of competition nationwide and to determine in specific markets whether the inappropriate exercise of market power is occurring and, where appropriate, to consider the range of actions available to address such problems.

STB initially disagreed with our recommendation because it believed the findings underlying the recommendation were inconclusive, their on-going efforts would address many of our concerns, and a rigorous analysis would divert resources from other efforts. However, in June 2007, STB stated that it intended to implement our recommendation using funding that was not available at the time of our October report to solicit proposals from analysts with no connection to the freight railroad industry or STB proceedings to conduct a rigorous analysis of competition in the freight railroad industry. On September 13, 2007, STB announced that it had awarded a contract for a comprehensive study on competition, capacity, and regulatory policy issues to be completed by the fall of 2008. We commend STB for taking this action. It will be important that these analysts have the ability that STB has through its statutory authority to inquire into railroad practices as well as sufficient access to information to determine whether rail rates in selected markets reflect justified and reasonable pricing practices, or an abuse of market power by the railroads. The Chairman of the STB has recently testified that these analysts would have that authority and access.

We also recommended that STB review its method of data collection to ensure that all freight railroads are consistently and accurately reporting all revenues collected from shippers, including fuel surcharges and other costs not explicitly captured in all railroad rate structures. In January 2007, STB finalized rules that require railroads to ensure that fuel surcharges are based on factors directly affecting the amount of fuel consumed. In August 2007, STB finalized rules that require railroads to

report their fuel costs and revenue from fuel surcharges. While these are positive steps, these rules did not address how surcharges are reported in the *Carload Waybill Sample*. In addition, STB has not taken steps to address collection and reporting of other miscellaneous revenues—revenues deriving from sources other than fuel surcharges.

As stated earlier, STB has also taken steps to refine the rate relief process since our 2006 report. STB has made changes to the rate relief process that it believes will reduce the expense and delay of obtaining rate relief. While these appear to be positive steps that could address longstanding concerns with the rate relief process, it is too soon to determine the effect of these changes to the process, and we have not evaluated the effect of these changes.

Mr. Chairman, this concluded my prepared statement. I would be happy to respond to any questions you or other Members of the Committee may have at this time.

Contact and Acknowledgements

For questions regarding this testimony, please contact JayEtta Z. Hecker on (202) 512-2834 or heckerj@gao.gov. Individuals making key contributions to this testimony include Steve Cohen (Assistant Director), and Matt Cail.

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