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United States Government Accountability Office
Washington, DC 20548

November 8, 2006

The Honorable Charles D. Nottingham
Chairman
Surface Transportation Board

Subject: *Freight Railroads: Highlights of GAO Report on Freight Rail Industry Performance, Competition, and Capacity*

Dear Mr. Chairman:

Over 25 years ago, Congress transformed federal freight rail transportation policy. At that time, after almost 100 years of economic regulation, the railroad industry was in serious economic decline, 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. This process establishes a threshold for rate relief, allowing a rate to be challenged if it produces revenue equal to or greater than 180 percent of the variable cost of transporting a shipment.

Since the passage of the Staggers Rail Act in 1980, we have issued several reports on the freight railroad industry. On October 6, 2006, we issued our most recent report.[1] The objectives of this report were to determine (1) the changes that have occurred in the freight railroad industry since the enactment of the Staggers Rail Act, including changes in rail rates and competition in the industry; (2) the actions STB has taken to address concerns about competition and captivity and any alternative approaches that could be considered to address remaining concerns; and (3) the projections for

[1]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).

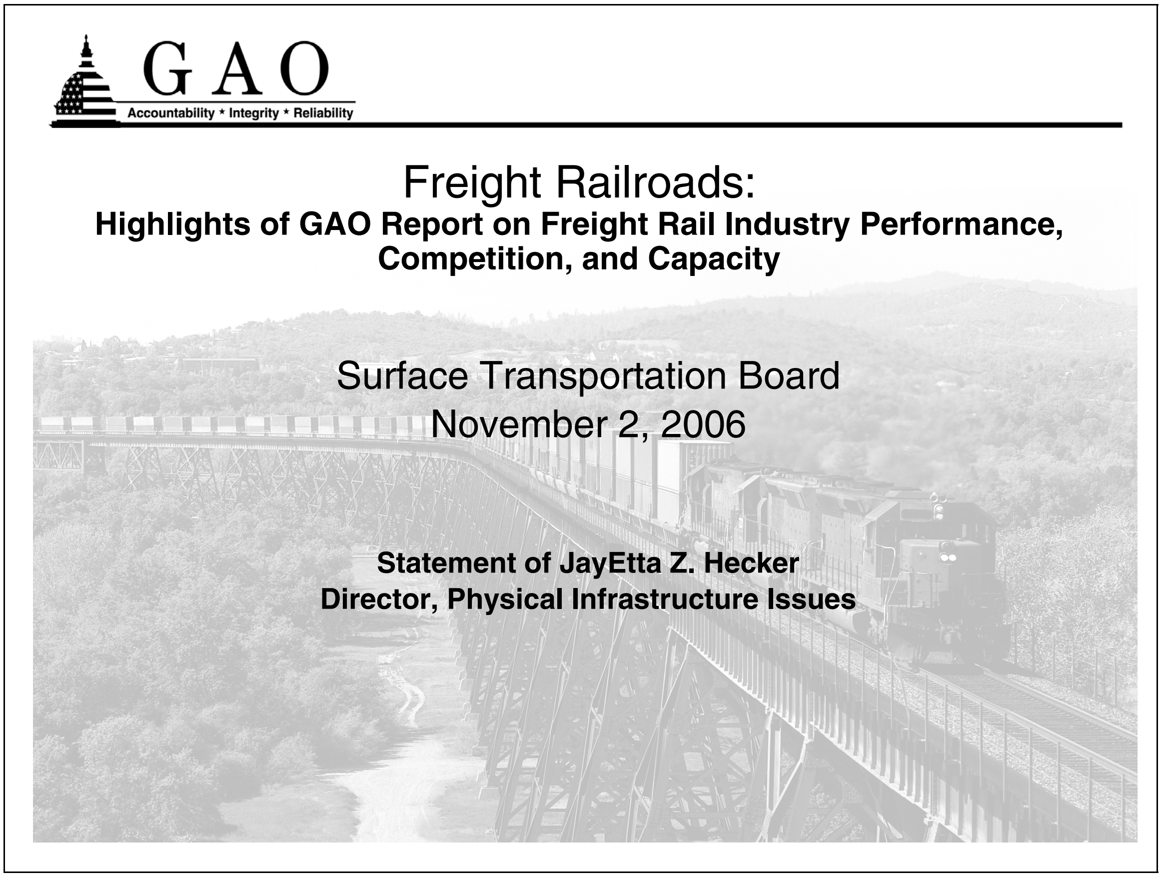
freight traffic demand over the next 15 to 25 years, the freight railroad industry's ability to meet that demand, and potential federal policy responses. Among other things, this report describes the significant changes that have taken place in the railroad industry and reports that from 1985 through 2004, rates generally decreased, but nominal grain rates increased 9 percent. We also found that, on some routes, the amount of grain traveling at rates significantly above the threshold for rate relief had increased since 1985.

In light of these findings, you asked us to testify before the Surface Transportation Board on November 2, 2006 at a hearing on grain rail rates. The enclosure is my presentation to the Board from that hearing. A copy of our October 6, 2006, report can be found at www.gao.gov.

Sincerely yours,

JayEtta Z. Hecker
Director, Physical Infrastructure Issues

Freight Railroads: Highlights of GAO Report on Freight Rail Industry Performance, Competition, and Capacity



Objectives of GAO Review

1. Changes in the railroad industry since the Staggers Rail Act of 1980, including changes in rates and competition;

2. STB actions to address competition and captivity concerns and alternatives that could be considered; and

3. freight traffic demand and capacity projections and potential federal policy responses.

- Report issued October 6, 2006; GAO-07-94 is available at www.gao.gov

Scope and Methodology

- Reviewed STB data, including the unmasked Carload Waybill Sample[1] from 1985 through 2004
- Interviewed railroad officials, shippers, and other parties
- Reviewed and analyzed projections for freight rail demand and capacity
- Convened an expert panel
- Review conducted from June 2005 to August 2006 in accordance with generally accepted government auditing standards

[1]The unmasked Waybill Sample does not disguise revenue data

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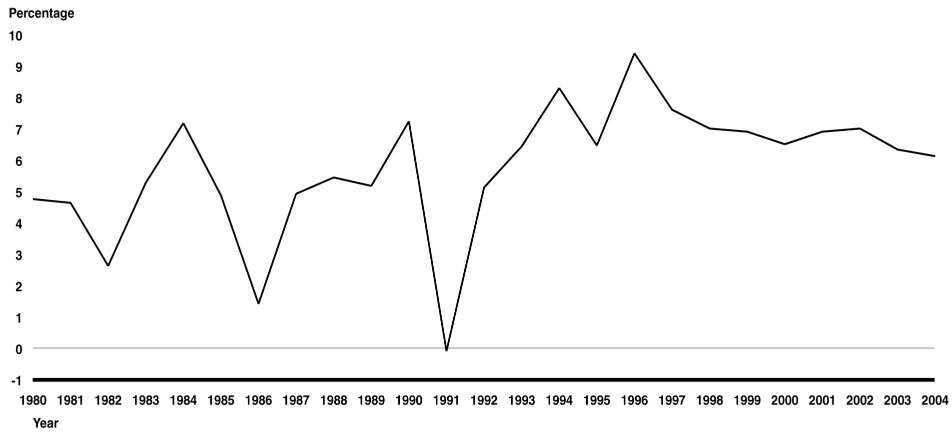
Changes Since Staggers: Industry's Financial Health Has Improved Substantially

Railroads' Tax-adjusted Return on Investment



Source: STB.

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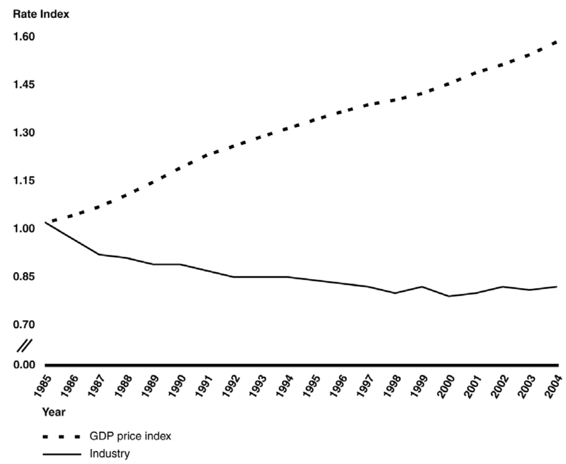
Changes Since Staggers: Industry Rail Rates Declined from 1985 through 2000 and Rose Slightly from 2001 through 2004



Source: GAO analysis of STB data.

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Changes Since Staggers: Some Revenues Have Increased, Some Costs Have Been Shifted to Shippers, and Some Charges Are Not Accurately Tracked

- Some revenues reported as miscellaneous have increased (e.g. fuel surcharges)
- Some costs have been shifted to shippers (e.g. railcars)
- Some charges are not accurately tracked (e.g. “miscellaneous revenue”) which limits completeness of Waybill data

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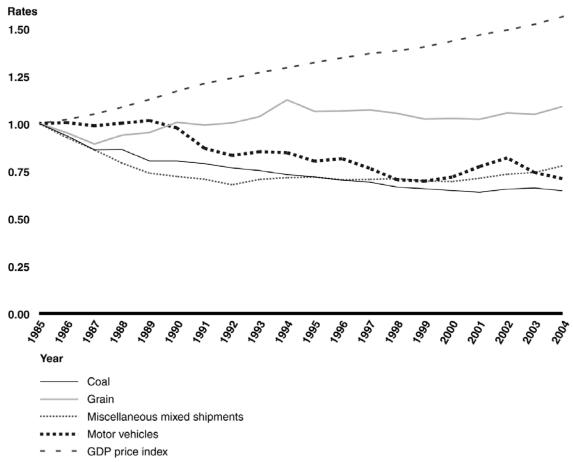
Changes Since Staggers: Unlike Rates for Other Commodities, Nominal Grain Rates Have Increased

Commodity Rate Changes



Source: GAO analysis of STB data.

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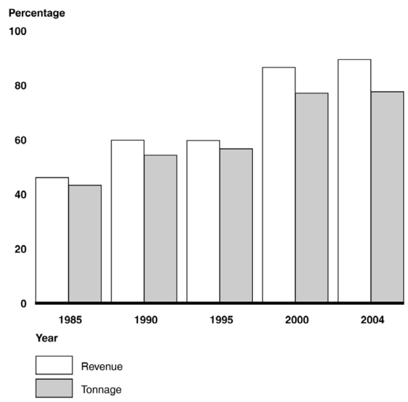
Changes Since Staggers: Competition and Captivity Concerns Remain

- Industry Has Become More Concentrated

Market Share of Four Largest Class I Railroads



Source: GAO analysis of STB data.

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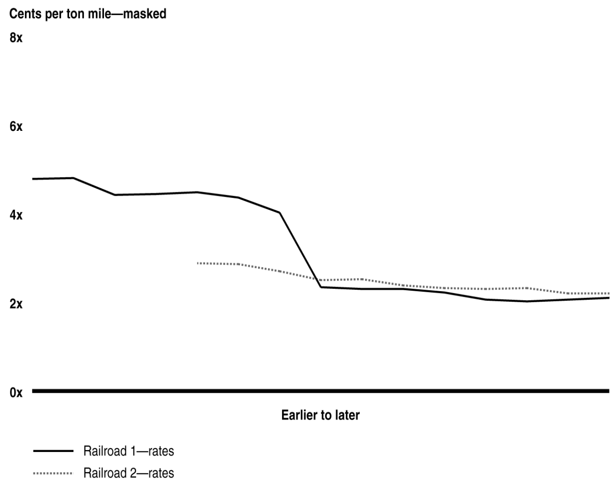
Changes Since Staggers: Competition and Captivity Concerns Remain

- Competition can lower some rates

Rate changes after shipper gained access to a second railroad at an origin point that had previously been served by one Class I railroad. We do not provide information on the location of the shipper involved because doing so could reveal proprietary information.



Source: GAO analysis of STB data.

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Changes Since Staggers:
Competition and Captivity Concerns Remain

- Captive Shippers are difficult to identify because available proxy measures can overstate or understate captivity

  - The Bureau of Economic Analysis' (BEA) economic areas can be quite large and our analysis does not include other transportation alternatives

  - Revenue to variable cost (R/VC) ratios can increase when the rate decreases

Year	Revenue collected	Variable costs	R/VC
Year 1	$20.00	$12.00	167%
Year 2	$18.00	$10.00	180%

Source: GAO

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Changes Since Staggers: Competition and Captivity Concerns Remain

- GAO's analysis of limited available measures indicates that:
  - extent of captivity appears to be dropping
  - the percentage of traffic traveling at rates substantially over the threshold for rate relief (over 300 percent R/VC) has increased

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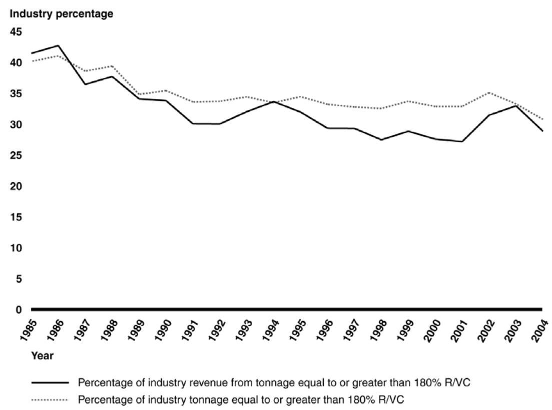
Changes Since Staggers: Competition and Captivity Concerns Remain

- Less traffic is traveling at rates equal to or greater than 180 percent R/VC

Tonnage and revenue generated from traffic traveling at rates equal to or greater than 180 percent R/VC



Source: GAO analysis of STB data.

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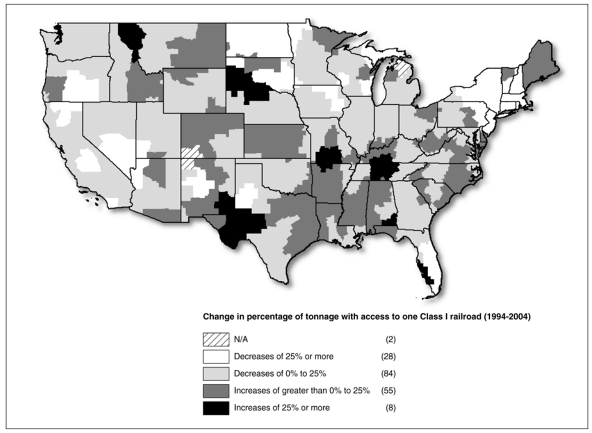
Changes Since Staggers: Competition and Captivity Concerns Remain

- Tonnage with access to more than 1 Class I railroad appears to have increased

Change in Percentage of Tonnage with Access to One Class I Railroad, 1994 through 2004



Source: GAO analysis of BEA, DOT and STB data.

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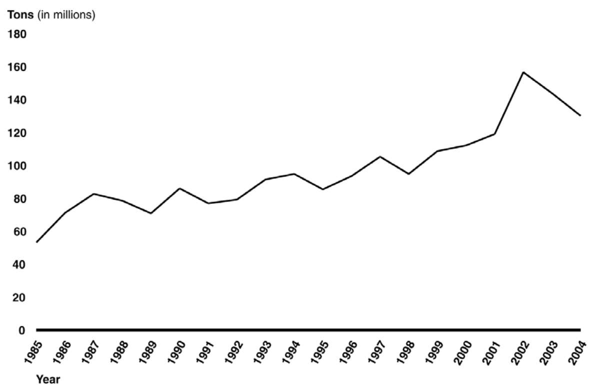
Changes Since Staggers:
Competition and Captivity Concerns Remain

- Amount of traffic traveling at rates over 300 percent R/VC has increased

Tonnage traveling at Rates Over 300 Percent R/VC



Source: GAO analysis of STB data.

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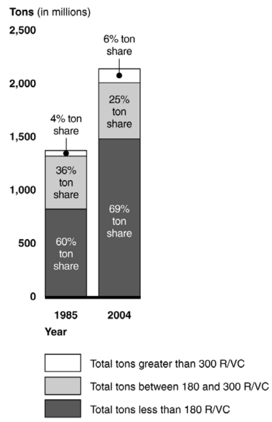
Changes Since Staggers: Competition and Captivity Concerns Remain

- Amount of traffic traveling at rates over 300 percent R/VC has increased

Percentage of Tonnage by R/VC, 1985 and 2004



Source: GAO analysis of STB data.

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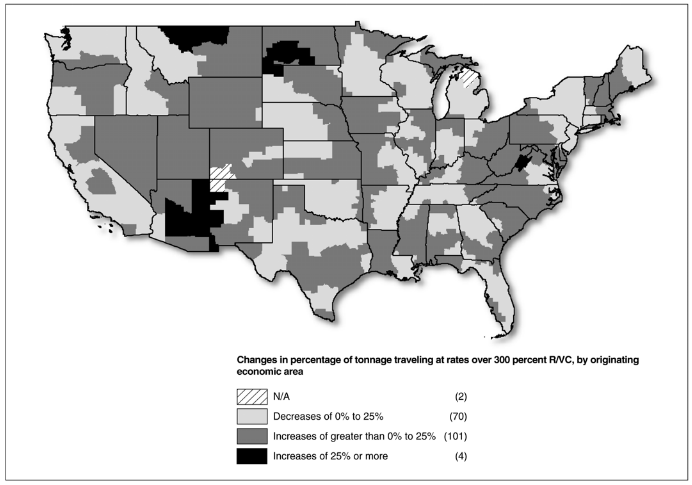
Changes Since Staggers:
Competition and Captivity Concerns Remain

- Increases in traffic traveling at rates over 300 percent R/VC appear widely distributed



Source: GAO analysis of BEA, DOT and STB data.

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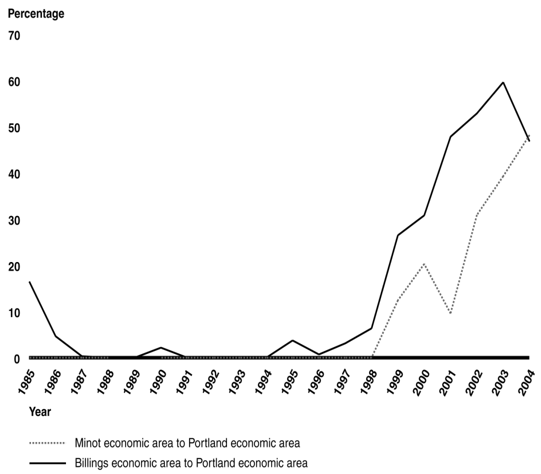
Changes Since Staggers: Grain Routes with High R/VC Ratio

- Some grain routes had significant increases in traffic traveling at rates over 300 percent R/VC

Percentage of tonnage traveling over 300 percent R/VC from Minot to Portland and Billings to Portland



Source: GAO analysis of STB data.

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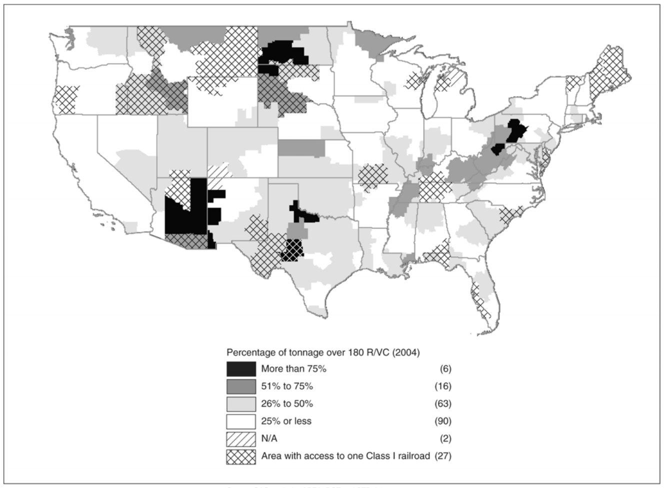
Changes Since Staggers:
Competition and Captivity Concerns Remain

- Some areas with access to only one Class I railroad have a higher percentage of traffic traveling at rates over 180 percent R/VC



Source: GAO analysis of BEA, DOT and STB data.

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STB Actions and Alternative Approaches

- STB has broad statutory authority to monitor the railroad industry, including the authority to inquire into and report on rail industry practices

- STB has taken actions to protect captive shippers
  - simplified guidelines
  - reviewed rail access and competition

- Efforts have led to little effective relief

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STB Actions and Alternative Approaches

- Assessment of competitive markets could more clearly identify areas for targeting STB action
  - The results of our analysis suggest a reasonable possibility that shippers in selected markets may be paying excessive rates related to a lack of competition in these markets
- A number of approaches could make the rate relief process more accessible but each has both advantages and drawbacks
  - Increase the use of simplified guidelines
  - Increase the use of arbitration
  - Develop an alternative cost methodology
- Any alternative approach requires careful balancing between the railroads' need for revenue and shippers' need for reasonable rates

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Future Demand, Capacity, and Potential Federal Response

- Forecasts of significant future freight rail traffic growth
  - DOT projects domestic and international freight demand increases of more than 65 percent and 84 percent, respectively, from 2002 to 2020
- Railroads' ability and willingness to invest in new capacity to meet demand reflects a number of key considerations, and capacity to meet potential demand is uncertain
- Rail capacity investments can produce private and public sector benefits
  - Reduces highway traffic congestion
  - Improves air quality
  - Enhances intermodal connections
- Public sector investment in freight rail is growing
  - Over 30 states have published freight rail plans
  - Federal investment includes $100 million for Chicago's freight rail infrastructure

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Future Demand, Capacity, and Potential Federal Response

- The Department of Transportation (DOT) is developing a national freight policy
- The federal response to freight investments should be impartial toward all modes and produce maximum public benefits from public investments
- A mode neutral approach
  - Federal programs treat different freight modes differently
- Maximizing public benefits
  - Benefit-cost tools often not effectively used
  - States have experience evaluating whether freight rail projects warrant investing public dollars
  - Federal decision makers have no such criteria

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Conclusions

- The Staggers Rail Act achieved far-ranging benefits, most shippers are better off, and widespread changes to the relationship between railroads and their customers are not needed
- Pockets of potential captivity and other factors raise the question of whether some rates reflect reasonable pricing practices or an abuse of market power
- Although our analysis is constrained by the limitations in the Waybill and available proxy measures, it is an important first step
- STB has broad statutory authority to inquire into and report on rail industry practices
- Further actions require careful balancing between the railroads' need for revenue and shippers' need for reasonable rates
- Federal policy responses on rail capacity should reflect a mode-neutral national policy that produces maximum public benefits

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Recommendations
(from October 6, 2006 report)

- STB should undertake a rigorous analysis of competitive markets, determine whether the inappropriate exercise of market power is occurring in specific markets, and, where appropriate, consider the range of access available to address problems associated with the potential abuse of market power.
  - If STB determines that it requires more resources to conduct this analysis, then STB should request additional resources from Congress

- STB should review its method of data collection to ensure railroads are consistently and accurately reporting all revenues

- As DOT continues to develop a national freight policy and a possible federal policy response, it should consider strategies to (1) create a level playing field for all freight modes and (2) develop mechanisms to assess and maximize public benefits from federal investments.

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