STATEMENT
of the
ALLIANCE FOR RAIL COMPETITION

BEFORE THE SURFACE TRANSPORTATION BOARD

STB Ex Parte No. 582 (Sub-1)
Major Rail Consolidation Procedures
May 16, 2000

SUMMARY:

The Alliance for Rail Competition (ARC) believes that a review of railroad-merger policy procedures is long overdue and thus, commends the Surface Transportation Board (STB or Board) for undertaking this rulemaking process. Furthermore, ARC applauds the Board's stated intention to eliminate the "one case at a time" rule, as the comprehensive effect of the Board's decisions should always be taken into account. However, ARC strongly disagrees with the Board's decision to narrow its review to prospective merger standards, rather than broadening the scope of its investigation to include remedies for the serious problems emanating from past merger policies. These problems have been well documented in testimony from hundreds of rail customers in numerous proceedings initiated by the STB, and have been acknowledged by the railroads themselves. It would be inappropriate for the Board to ignore the inequities produced by past merger criteria as they have clearly undermined one of the major goals of the Staggers Rail Act of 1980 -- to avoid "undue concentrations of market power" among railroads. (Title I, Section 101a(13)). Furthermore, in the spirit of the Staggers Act -- that is, the preamble to that legislation -- ARC recommends that the STB base its revamped merger policies on indisputable findings, as noted below:

1. The four largest Class I railroads account for 95% of the industry's traffic, control even a greater portion, and operate as regional monopolies with only two controlling traffic in the West and two controlling traffic in the East.

2. There presently exist railroad-dependent customers who, in a number of markets, have no other viable transportation choice other than to rely solely on one of the two dominant railroads that serve the region.

3. If past trends continue, further consolidation will leave only two transcontinental railroad monopolies controlling the entirety freight rail traffic in North America.

4. Competition is preferable to regulation as an optimal allocator of resources, as a determinant of reasonable prices, and as a basis for customer-need satisfaction.

5. Adequate competition means alternative customer choice rather than similar service and rates offered by a limited number (two) railroads.

The increased concentration of railroad power fosteredy by the existing regulatory scheme has created regional monopolies fraught with problems. Managerial arrogance, insensitivity to customer needs, discriminate pricing, service deficiencies, and customers who become adversaries are not signs of the healthy, competitive railroad marketplace that Congress envisioned when crafting the Staggers Act. In essence, while we are troubled by the prospect of additional problems associated with future railroad mergers, **rail customers are already experiencing a de facto duopoly -- actually, a two-railroad monopoly.** The problems that come with this two-railroad monopoly should not have to wait for resolution until after a transnational—or transcontinental—two-railroad monopoly is created.

Certainly, rail merger policies must be reformed, but the Board cannot and should not avoid addressing the serious problems that already exist under the current configuration of both rail industry structure and the rail policies that govern that structure—regardless of whether the Board does so independently or by collaborating with Congress. There is but one answer that will resolve these problems: comprehensive rail policy reform aimed at restoring competition among rail carriers. This should be done before any further consolidation takes place. Competition has worked well for the rest of American industry. It should be given a chance to work in the railroad industry as well.

The remainder of this statement is divided into three segments. First, present STB merger policies are critically reviewed. Second, a set of merger principles is recommended for STB adoption. And finally, recommendations for a more comprehensive approach to these issues are outlined.

REVIEW OF MERGER POLICIES:

Past railroad-merger regulatory policy has largely been based on one assumption and one expectation. The assumption is that railroads are already monopolies in some markets, and that larger and expanded monopolies will not be any more detrimental to railroad customers. The expectation has been that mergers will create economic efficiencies that will be passed on to customers.

<u>One-Lump Theory</u>: In the first instance, the assumption of monopolization is illustrated by the Boards "one-lump theory" -- that is, that railroads have traditionally enjoyed monopoly markets and that mergers, while expanding those monopolies, do not put customers at any increased disadvantage. Real world application of this theory, however, left many rail customers who were captive at either origin or destination significantly disadvantaged as they frequently lost competitive choices they once had over significant portions of their routes. In fact, one of the reasons railroads merge is to acquire that captivity. As the rail industry consolidated, the extent of these rail customers' captivity continued to increase. Dr. Alfred Kahn, who testified on

ARC's behalf in the Ex Parte 575 proceeding, demonstrated this in the Conrail merger proceeding. Furthermore, railroad monopoly markets simply should not be tolerated, particularly when merger applications provide the opportunity to eliminate monopoly situations, for the fixed infrastructure can easily accommodate alternative providers.

3-to-2 vs. 2-to-1 Issues: It should also be understood that monopolization is relative. Two-railroad service is not necessarily better than one-railroad service, since two railroads are unlikely to engage in a self-defeating price war. However, three railroad competitors are unquestionably better than two. The concept that sufficient competition remains when a merger reduces the number of competitors from three to only two is not supported by any long-term behavioral evidence. Economic theory—borne out by the experience of many rail customers—holds that in the long run, oligopolists and/or dual monopolists will decide that competition on pricing or service is self-defeating because the other supplier will match it. Thus, railroad customers that have two railroads between which to choose will find their conditions, on average, only slightly better than those customers who have but one railroad. Without question, two railroads are better than only one, but as an overarching policy goal, two railroads simply are insufficient to ensure adequate competition.

Moreover, shorter-haul railroad monopolies are potentially less obtrusive than longer-haul monopolies because of the opportunity of interline shipping, proportionate rates, use of regional and/or local railroads, etc. And finally, larger railroad monopolies are potentially more destructive than smaller companies because they don't face the same countervailing power (customers that they equally depend upon) as do smaller railroads. The more extensive the railroad's monopoly power is, the less that railroad will perceive that it needs the business of any one customer, and it will behave toward that customer accordingly. Simply stated, monopolies have different levels of market power, and the Board must recognize this within its new merger policies and adopt approaches that will overcome extended monopoly power.

Benefits of Economies of Scale: In regard to the Board's assumption about economies of scale and/or density being realized and passed on to customers, the evidence is that much of the industry's downsizing and rationalization could have taken place without mergers. This is not to underestimate the need and value of infrastructure rationalization, but the Board has allowed the industry to go too far, as demonstrated by the extended monopoly power amassed by so few railroads. After all, maximum economic efficiency could conceivably be achieved by a single railroad, but not only would this be inconsistent with the pro-competitive elements of the existing statute, but it would be economically *inefficient* for the distribution system within which that railroad operates. For if inadequate service, relatively high freight rates, and customer insensitivity cause railroad customers to lose sales, experience higher transportation costs, create the need to stock more inventory, etc., then distribution efficiency declines. This is why railroad economies must be but one aspect of STB-merger criteria.

Denied Opportunities: Combined, the two aspects of past regulatory policy which accept and expand existing monopoly power and project economic efficiencies have helped to accelerate the rationalization of an overbuilt railroad infrastructure, but at the cost of severely limiting competitive options. In this regard, rail transportation markets have been denied the benefits that

may have been offered by the entry of new alternative providers who may have introduced even greater economic efficiencies, more advanced technology, more comprehensive innovation, and more sensitivity to customer needs.

At the same time, the present railroads complain of capacity constraints. Certainly, with continuing traffic growth at hand, the Board—and railroads themselves—should have been anticipating the potential growth of rail traffic and thus prohibited railroads from eliminating so much capacity, as well as many of the gateways and joint routes that once existed. Representatives of the railroad industry have often been quoted as saying "you don't build the church for Easter Sunday." However, because the proverbial church had already been built for Easter Sunday, today's capacity problems—which seem to conveniently fluctuate depending on whether the railroads would benefit more from over- or under-capacity—are more the result of poor planning and a merger policy that did not account for projections of how much capacity might be necessary in future years.

Paper and Steel Barriers: One of the most immediate means of beginning to correct the unintended consequences of past merger policy would be the elimination of paper and steel barriers. Short line and regional railroads offer the best and most immediate opportunity to provide increased levels of rail competition. However, many of these railroads were created when a Class I carrier "spun-off' a branch line—a decision that benefitted both the Class I carrier and the new operator of that line. Unfortunately, in many cases, part of the spin-off agreement contractually prevents the new operator from interchanging traffic with any other than the parent carrier. Allowing such contractual conditions precluding competition is clearly inconsistent with the intentions of the statute and should be eliminated. A similar situation exists when the Class I carrier removed a small portion of track to physically prevent movement of cars from the spun-off line's tracks to the tracks of a competitor of the parent railroad. The practice of erecting such "steel barriers" is equally anti-competitive and should be eliminated.

According to Dr. Alfred Kahn, such "paper and steel barriers" would essentially qualify as violations of Section I of the Sherman Anti-Trust Act which prohibits tying arrangements between businesses in the transfer of products and assets. Just because the railroad industry has immunity from Department of Justice anti-trust oversight does not mean that the Board cannot or should not address such anti-competitive practices. The Board should use its regulatory power to eliminate the railroads' practice of preventing competition through the application of paper and steel barriers. This action should address both existing paper and steel barriers as well as prohibiting such barriers in future transactions.

RECOMMENDED MERGER-POLICY PRINCIPLES:

Sound public policy toward future railroad mergers should be based on the following principles:

1. A Viable Freight Railroad Industry is in the Public Interest

Freight railroads are national assets that have the ability to provide relatively low-cost, energy-efficient and environmentally benign transportation service. They operate with a public

nature and responsibility. They have a duty to serve all of their customers, without whom they would cease to exist, without prejudice or discrimination.

2. Railroad Viability can be enhanced With Competition

The best means for ensuring the railroad industry's viability is to encourage carriers to compete among themselves, as well as with other modes of transportation. Competition is the engine that drives the free enterprise system. It pressures suppliers (railroads) to be efficient and can help railroads grow traffic.

3. The Net Impact on Customers should be the Key Merger Criterion

Even where economies of density are expected to be realized, railroad mergers should not be approved if the prospective cost reductions are offset by adverse service and/or rate impacts on railroad customers due to a diminishment of competition.

4. Competitive Access is the Preferred Protection for Customers

Railroad customers can be protected from the adverse effects of mergers, by providing for additional competitive access to captive customers served by the merged railroad, and/or by implementing effective economic regulation. Competitive access is preferable to regulation because it motivates carriers to be responsive to customer needs. Competitive access would benefit railroads in that the incumbents: (1) could charge adequate user fees, (2) would experience traffic growth, and (3) would in turn realize newly-found economies of traffic density.

5. Railroad Customers Need Safe Harbor Protection

In the absence of effective railroad competition, economic regulation is necessary to insure that service is adequate and freight rates are reasonable. Opening access and economic regulation is not an either-or choice; they are parts of a whole.

6. Railroad Mergers Are Not the Only Way to Lower Operating Costs

Traffic growth is a key to economies of railroad track density. Aside from traffic growth, railroads can reduce costs through a wide variety of managerial and technological means. Railroads have controlled their cots by eliminating inefficient service, reducing crew sizes, changing operating and work rules, and employing new technology.

7. Post-Merger performance Must be Closely Monitored

The STB should establish procedure to measure post-merger performance and should issue an annual report of its findings for a period of 10 years.

8. Where Desirable, Adjustments Should Be Made

When railroad mergers cause unanticipated adverse impacts on customers, or competitive alternatives provided for within a merger proceeding are determined to have either not worked or disappeared, the situation can be rectified *post merger* by opening competitive access and/or making economic regulation more effective.

RECOMMENDATIONS:

The problems and concerns expressed as part of Ex Parte No. 582 did not suddenly arise on December 20, 1999 when the announcement was made that BNSF and CN intended to merge. A growing number of rail customers have loudly and repeatedly raised these issues for a number of years in forums ranging from the past several mergers and the Board's Ex Parte No. 575 proceeding on Competition and Access, to various Congressional hearings in both the House and Senate. A revision of merger policy for future merger applications must be completed, but the evaluation and revision of merger policy is just the first step toward resolving the many problems facing today's rail industry.

The Board should approach its task in a more comprehensive manner. Beyond adopting merger principles that emphasize competition among railroads to the maximum extent possible, the Board should:

1. Make policy revisions that would provide realistic means of regulatory relief for rail customers that do not have the benefit of such competition. This might include the development of a final offer arbitration system, similar to that used in Canada, to provide an efficient and cost-effective alternative to costly, lengthy regulatory proceedings.

2. Change the revenue-adequacy criterion to a simply measure of "allowable return on equity," similar to the public utility industry. The statute does not specify how the Board should measure revenue adequacy, only that it must do so. Making the measurement relevant to real world performance would be a strong step toward balancing the regulatory arena for those rail customers who are willing to try to request regulatory relief from monopoly pricing practices and removing the prop that railroads point to in opposing the introduction of competition.

3. Undertake efforts to eliminate paper and steel barriers to competition between Class I carriers and short line and regional railroad operators.

4. Recommend legislative amendments that would permit further reliance on competition in the rail policy arena. In light of the market power held by today's rail system configuration, a new standard should be applied to address bottleneck situations and decisions relating to access in terminal areas. Since the board previously indicated that it does not believe it has the authority to correct these policies independently, we suggest the Board either support S. 621 in the Senate and H.R. 2784 or H.R. 3446 in the House, or forward its own set of legislative recommendations for resolving the well-documented problems associated with the lack of competition among rail carriers. While this Board clearly has been working in specific areas where it believes it has the authority to address concerns of dwindling competition, a stronger recognition to the Congress that there are serious problems that can only be grappled with in the legislative arena is an important signal that change is necessary and cannot be avoided.

5. Work with rail customers and Congress to develop legislation and pass into law an appropriate method for providing protections for small captive railroad customers. This is consistent with Chairman Morgan's December 1998 letter to Senators McCain and Hutchison in which she indicates that resolution of this particular problem will require congressional action.

Since Congress relies on this Board for guidance, a more active dialog between the Board and congressional leaders on this issue would seem to be appropriate.

6. Adopt an approach to rail policy as something that must evolve as the industry evolves. Integral to this new approach would be a strong and more comprehensive view of how to facilitate competition. The pro-competitive changes advocated by rail customers today are consistent with the existing 20-year old statute, and thus, are really quite modest, particularly in comparison to what other similarly positioned industries are facing. However, modest pro-competitive changes today should not preclude additional changes as the characteristics of the rail industry change. Policy should be a living process that changes to meet the needs of a quickly changing marketplace.

ARC stands ready to work with the members of the STB in support of the recommendations outlined herein.

Submitted by:

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CERTIFICATE OF SERVICE

I hereby certify that this statement of the Alliance for Rail Competition has been duly served on all Parties of Record identified on the Ex Parte 582 (Sub-1) service list via first class mail in the United States Postal Service this 16th day of May, 2000.

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