FUTURE CHALLENGES FOR PRIVATE SECTOR RAILROADS

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While serving at the Federal Railroad Administration, I often had opportunity to brief foreign delegations seeking insight into the structure of the private sector U.S. freight railroads.

The visitors were particularly interested in learning how to attract and integrate private capital into their national systems. They also wanted to know how the merger movement impacted U.S. freight rail operations.

I answered not from a canned government briefing paper, but from the perspective of a more than 30-year railroad law practice bracketed by service as the ICC's chief of litigation at the threshold of the *Staggers Rail Act,* and as FRA's policy chief when the federal government's new rail-merger guidelines were promulgated.

My concern for the future of the private sector rail industry often surprised our visitors. They had, after all, come to Washington to be guided by our approach to private sector railroading. Upon reflection now from a somewhat detached perspective as a professor of intermodal transportation at the Merchant Marine Academy, I think that the concerns first voiced to foreigners may well be raised for this readership.

In short, I stated my views that, the principal public policy issues facing our now-highly concentrated U.S. railroad industry will shift from competition to capacity. To face the oncoming real, as opposed to self-created, capacity constraints, U.S. railroads will need extensive federal assistance to maintain and enlarge their infrastructure.

(In other words, there will be a convergence of other national rail systems seeking private capital investment with the private sector U.S. roads seeking federal support.)

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Also, the great growth of international intermodal traffic will demand that railroad infrastructure development keep apace with its federally assisted modal partners' in global supply chains to maintain overall *system* efficiency.

Finally, the functional shift of the U.S. rail industry (dominated by the Class Is) from a many-carrier common carriage network to essentially a contract carriage oligopoly, will make federal assistance to private infrastructure development more difficult -- or, at least, more condition ridden.

In stating these concerns to our visitors, I briefly touched on the sweeping functional changes brought about over the past quarter century by partial economic deregulation, the cumulative impact of the rail merger movement, and the related maturation of logistics as a management science.

I'll touch on logistics and the impact of supply chain management later, but here it may be useful to review the functional changes in railroad commerce in the context of the balance between the carriers and shippers prior to the *Staggers Act*, during the implementation of the act, and now in light of the great consolidation of the rail industry brought about by the mergers of the 1980s and 1990s.

THE PRE-STAGGERS BALANCE

To get a feel for the operational impact of the *Staggers Act* and the railroad merger movement on today's rail industry, it is useful to remember the strategic balance between the carriers and shippers that existed prior to the act.

It is equally important to remember that the environment engulfing that relationship was one of an increasing perception of institutional failure, both governmental and commercial.

After the collapse of Penn Central and its various connecting Northeast railroads, and the growing threat of further Midwest railroad failures, Congress could no longer ignore this vital industry or leave its problems to the ICC to be sorted out under unchanged regulatory statutes.

Prior to the *Staggers Act,* the shipping community enjoyed certain protected benefits such as:

Railroad Connectivity: It has long been established law that U.S. railroads must interchange traffic without discrimination throughout the extensive system. Mandatory interchange, along with growing inter-carrier trackage rights (either imposed as merger

conditions or voluntarily assumed) made the multi-carrier U.S. railroad system operate as a true network.

Given the vast number of actual and potential interchanges in the 170,000 + mile network, along with the requirement for rate tariff transparency and non-discrimination, the shippers enjoyed broad routing powers in selecting alternative carriers and carrier combinations.

Common Carrier Obligations: While shippers had access to myriad route combinations for their traffic, they also could rely on the ICC to enforce service obligations by potential carriers over these different routing combinations.

Non-Discrimination: Bolstering the shippers' routing options was the assurance that they had remedies available at the agency if there was any perceived discriminatory treatment. In retrospect, the ICC spent an inordinate amount of enforcement effort tracking down and disciplining carriers appearing to give preferred shippers special "unwarranted" treatment. Contract-like preferences were illegal *per se.* This had a profound impact on railroad management, effectively emasculating any real marketing initiatives, much less a marketing orientation, prior to the *Staggers Act.*

Confidence in Rate Adjudication: Regardless of one's philosophical view of the underlying policy, the ICC had acknowledged expertise concerning the tariff-based railroad rate structure. Shippers had no hesitancy turning to the agency to invoke its adjudicatory processes in this area.

The carriers, on the other hand, did not have corresponding comparative advantages prior to the *Staggers Act.* They could not effectively offer their services under the full range of marketing techniques. Nor could carriers promote special shipper relationships without risking undue attention by the commission's Bureau of Enforcement.

The carriers could, however, invoke the commission's process to adjust their overall rate base by means of general revenue proceedings. In these *ex parte* proceedings, the rail industry periodically presented voluminous data supporting requests for across-the-board revenue enhancements. These proceedings, however, always begot extensive litigation both before the agency and in court, with the resulting delay often eating the very relief sought. The fact that the industry, as a whole, could not earn its cost of capital, graphically underscored the weakness of this so-called procedural advantage.

Attempting to balance the conflicting positions of the carriers and shippers at the threshold of the *Staggers Act* was a very powerful ICC. It enjoyed comprehensive powers over the industry.These ranged from rate and practice oversight, to merger jurisdiction, and also included extensive jurisdiction over passenger train service (prior

to the creation of Amtrak), securities jurisdiction (later ceded to the SEC in the wake of the Penn Central holding company debacle), abandonments and bankruptcy reorganizations (greatly reduced by the *Bankruptcy Reform Act* of 1976).

The agency was well staffed to meet its extensive responsibilities with more than 70 administrative law judges in place to hear its burgeoning administrative case load.[1]

When judicial review of the ICC's decisions passed from the special three-judge district courts to the U.S. courts of appeal under the *Hobbs Act* in 1977, the case load of the U.S. Court of Appeals for the DC Circuit more than doubled.[2]

In short, the agency, which tried to balance the interests of carriers and shippers pursuant to statutory congressional policy prior to the *Staggers Act*, was a powerful one. But it became increasingly clear that exercises of its power without a change in the underlying policy could not save the industry from collapse. A congressional policy change, the *Staggers Act*, had to do that.

FUNCTIONAL CHANGE: STAGGERS' *IMPLEMENTATION*

In a real sense, today's railroad practices and structure have their origins in the creeping bankruptcies of the 1970s.

In 1970, the rail industry was in distress. The Penn Central reorganization was proving to be too large and complex for the court to handle.[3]

The giant carrier's problems were not isolated. Six other Northeast railroads accompanied Penn Central into bankruptcy. In the Midwest, the Chicago, Rock Island & Pacific was teetering toward bankruptcy, soon to be followed by the Chicago, St. Paul, Milwaukee and Pacific Railroad. More than 25 percent of the nation's rail plant

[1] Admittedly, the bulk of its cases involved the motor carrier industry, which was highly litigious at the eve of the *Motor Carrier Act* of 1980. Yet, the ICC remained the busiest of the regulatory agencies in terms of administrative litigations.

[2] The ICC, the first federal regulatory agency, enjoyed special judicial review status. As its jurisdiction was initially grounded on the Constitution's Commerce Clause, judicial review of its orders was long held in the three judge district courts empaneled to hear constitutional issues. At the time, the ICC was brought into alignment with the other regulatory agencies concerning judicial review in the courts of appeal, there was no statute of limitations concerning judicial review of ICC orders. Thus, a massive backlog of appellate cases was dumped on the nation's courts of appeal when jurisdiction shifted to them.

[3] Then, prior to the *Bankruptcy Reform Act*, railroad reorganizations were conducted in federal district courts rather than in specialized bankruptcy courts as is the case today. Moreover, prior to the change in the bankruptcy law, the ICC had simultaneous joint jurisdiction with the district court.This awkward situation led to delay and duplication of effort.

(as measured by mileage) was under the control of bankruptcy trustees. Rail dependent heavy industry was threatened with failing, but necessary, rail service.

In these circumstances, Congress faced difficult choices.

To appreciate the complexity of the issues facing Congress with the incipient collapse of the private sector rail industry, one simply had to look at the state of the industry as it existed in the 1970s prelude to the *Staggers Act.* Similarly, to appreciate the profound operational changes wrought by the merger movement unleashed by the *Staggers Act*, we should keep in mind the shippers' pre-*Staggers* comparative advantages outlined above.

In 1970, there were more than 40 Class I railroads making up the patch work quilt of the U.S. rail system. This multiplicity of carriers, however, was forced to operate as a network by laws compelling mandatory interchange under an initiative stifling uniform rate structure embodied in public tariffs and enforced by a powerful agency. Preferential treatment of any shipper, no matter how important, invited scrutiny from the ICCs Bureau of Enforcement.

It is no surprise that railroad marketing initiative was frustrated under this regime.[4] Railroad marketers developed more of a public utility mentality than an entrepreneurial spirit under the commission's execution of its perception of congressional policy.

Congress thus faced a demoralized, but economically necessary, private sector industry when it passed the *Staggers Act,* effectively deregulating the bulk of the railroads' rate structure. While it kept in place the mandatory interchange practices that forged a system out of interconnected carriers, it allowed individual contract ratemaking. This is the key to the industry's revitalization. It is also the spark that ignited the merger movement.

Instead of behaving like public utility tariff filers, railroad marketing departments were encouraged to act like other business marketers, to negotiate individual transportation arrangements with different customers. This simple, but important, step invited innovation.

Under the old regime, shippers had an advantage in that the tariff rates were uniform, published, known and enforced, while routing alternatives over the

[4] A classic example of this frustration arises out of the so-called Big John case in which marketing executives on the Southern Railway developed a new, large 100-ton aluminum covered hopper car and established volume rate discounts in order to provide intermodal competition to truckers moving feed-grains to the Southeast only to have the ICC squelch the project after the carrier had obtained the new car fleet. *See*, for example, Frank N. Wilner, *Comes Now the Interstate Commerce Practitioner* (Association for Transportation Law, Logistics & Policy, 1993), pp. 157-158.

interconnected network remained the shippers' prerogative. Now, the carriers can offer tailored alternatives on the rate side of the rate/route equation.

It didn't take very long for the carriers to realize that economic advantage arises from the ability to make transportation contracts over the longest haul possible, thereby cutting former joint line partner/competitors out of the deal. The best way to lengthen long-haul possibilities is to lengthen a carrier's geographic reach. In other words, the *Staggers Act's* rate freedoms, especially contract ratemaking, set the stage and encouraged the rationalization of the U.S. rail industry by means of strategic mergers between connecting carriers.

The industry seized the opportunity to assure market share through merger. Over the past 20 years, the 40-plus Class Is merged themselves into a now-stable industry structure of four mega-systems and a relatively small collection of regional railroads.[5] In the merger process, the large trunk line carriers often spun off duplicative rail plant to new short line carriers. There are now upwards of 600 short lines with varying degrees of participation in the national rail system.

The merger movement not only produced corporate concentration, it significantly changed the physical flows over the total rail network. The merged carriers emphasized high density lines by channeling freight onto their most efficient corridors at the cost of other previously competitive alternate lines.

These carriers have succeeded in building density over preferred lines to such a degree that they have already experienced capacity constraint problems well in advance of the predicted onslaught of new international/intermodal traffic flows.

The Department of Transportation predicts that rail traffic will grow by 50 percent by 2020.(Freight Analysis Framework, 2002).The scope of the oncoming capacity problem was only hinted at by Norfolk Southern and CSX's problems digesting new traffic flows arising out of the Conrail split.

Equally, or perhaps more important, the *Staggers Act*-inspired merger movement has turned the previously discussed competitive situation of shippers and carriers on its head. As we face the coming era of capacity constraints, this may have significant consequences when the rail industry finally turns to the federal government as a partner in infrastructure maintenance and development.

[5] *See,* for example, Frank N. Wilner: *Railroad Mergers: History, Analysis, Insight* (Omaha: Simmons Boardman Books, 1997).

NEW POST-MERGER RELATIONSHIPS

We can now begin to assess the Staggers Act- inspired mergers' collective impact on shipper-carrier relationships using the comparative advantage measures outlined above. Simply stated, all the previous shipper advantages have been either diminished or nullified.

Railroad Connectivity: While mandatory interchange rules may technically still be in effect, there has been an enormous elimination of meaningful alternative routing possibilities in the post-merger railroad map. As the mega-systems have channeled traffic onto their favored high density lines, the less favored, formerly competitive lines, have either been sloughed off or have suffered comparative neglect as the surviving carriers marshal their limited infrastructure resources to their favored lines. On a simpler basis, the reduction of 40-plus Class Is to four mega-systems has eliminated all the constituent pre-merger routing alternatives. This is no longer a shipper comparative advantage.

Further, there is growing concern that the Class I's density packing techniques are slowly disconnecting the short lines from full participation in the network. Heavier cars and volume driven ratemaking are making it increasingly difficult for many short lines and their constituent shippers to remain meaningful participants in the system. This has long range policy implications that are not necessarily advantageous to the economy.

Common Carrier Obligations: While there may still be vestiges of the common carrier obligation in the rail industry, under the current Class I traffic mix it is approaching practical meaninglessness. Given the extent of explicitly deregulated traffic (such as boxcars) and the vast preponderance of other traffic moving under transportation contracts, the principal carriers have relatively fewer resources available for common carrier operations. While it is conceivable that a shipper could bring an action to enforce the obligation, in practical terms the Class I railroad industry is becoming a "contract carriage" industry.

Non-Discrimination: This has been totally revoked by the *Staggers Act*. The former ICC's whole mechanism for individual shipper protection no longer exists under the contract carriage regime.

Confidence in Rate Adjudication: A look at the Surface Transportation Board's active docket quickly shows that shippers are not turning to that forum for rate relief. Of course, the bulk of the rate relationships between shippers and carriers have been deregulated, but of those categories that remain subject to regulatory jurisdiction the lack of action may be partially explained by the complexity and expense of bringing a case under the "stand alone" costing procedures. The expense of the remedy has not been

shown to warrant the potential rewards. The absence of small shipper recourse to the board is particularly telling. Whatever the reason, shippers are simply not using the board's procedures. Non-use of available remedies is tantamount to a vote of no confidence.

The carriers, on the other hand, have completely reversed their position under the *Staggers Act*. Instead of general revenue proceedings, the carriers' use of contract ratemaking (based on the market power of the surviving merged carriers) has saved the industry from nationalization. But this has come at the cost of essentially changing the former interconnected common carriage network industry into a contract carrier oligopoly.

Finally a brief comparison of the post-mergers Surface Transportation Board with the pre-*Staggers* ICC is in order.

Congress has greatly reduced the board's power vis-à-vis the ICC's. The board cannot be faulted for that. Further, the rate expertise that was built over the years at the ICC cannot be expected to be duplicated by the very much smaller STB staff. Yet, a continuing complaint is made that the STB has not provided an adequate forum and procedures for shippers large or small. The relative paucity of rate cases at the board speaks volumes.

THE LOGISTICS REVOLUTION

Without attempting a cause/effect analysis, we can now briefly touch upon the logistics revolution that accompanied railroad rate deregulation and the merger movement.

The confluence of computer technology, containerization and the maturation of logistics as a management science occurred in parallel with the post-*Staggers* restructuring of the rail industry. Together, they have created a new dynamically responsive physical flow marketplace that is increasingly intermodal and seamless in nature.

The market orientation of post-*Staggers* rail management has played an important role in the ongoing development of effective supply chains, both domestic and international. But as this scientific approach to distribution increasingly replaces the old move/store/move channels of distribution, the need for continuous infrastructure development and improvement becomes ever more important. At a minimum, rail infrastructure development must keep pace with the other modes.

But a real question arises as to whether an unaided private sector railroad industry has the ability to shoulder the financial burden necessary to meet the needs of tomorrow's infrastructure development. Another way to put it is whether the public will allow an essential element of developing supply chains to slip out of sync with its partners because of lagging infrastructure investment.

In my view, capacity enhancement will be the capstone of the *Staggers* revolution. In an increasingly integrated transport marketplace, this will call for the participation of the carriers, the government and the shippers (at least by way of recognizing that rate adjustments may be necessary to provide additional capability for infrastructure investment).

But the current trend of the rail industry away from the former multi-carrier common carrier network toward a big-four dominated contract carriage oligopoly may make such broad shared interests between carriers, government and all shippers problematical.

Perhaps a first step toward the development of a necessary feeling of inclusion on the part of all shippers and a common interest in expanding the infrastructure ,whether it remains exclusively in the private sector or not, would be the creation of a more shipper accessible rate forum at the STB.

CONCLUSION

The *Staggers Act* has worked by freeing railroad marketing initiatives, which are now apparently limited only by the industry's physical infrastructure.

But today's private sector rail infrastructure will be insufficient to the face clearly projected traffic growth, much less future logistics and supply chain developments. The accommodation of railroad marketing initiatives with the realities of financing tomorrow's infrastructure will be the challenge facing the next generation of top rail management.

If, indeed, the time is approaching to begin to forge an infrastructure development partnership, the *Staggers*-based shift toward a contract carrier oligopoly will make justification for such a partnership more difficult. The time is now to begin to redress the balance between shipper and carrier interests altered by the *Staggers* initiated merger movement. All shippers, along with the government, should be full partners in building a rail infrastructure equal to the demands and opportunities of the clearly foreseeable future.