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The Changing Landscape of U.S. Railroads

Rails are carrying more volume at higher rates as shippers complain about competition restraints. BY DAN MCCUE

The North American rail industry's almost uncanny ability to shift gears and shake off declining loads of consumer goods and automobiles after the collapse of the U.S. housing market appears, for the time being, to have spared it the worst effects of the economic downturn.

Through at least the third quarter of 2008, shipments of agricultural products, chemicals, metals and minerals, and particularly, coal—long considered a "defensive cargo" because demand for it doesn't drop off in time of economic weakness—have been very good for the nation's Class 1 freight haulers.

All four: the Union Pacific, the Burlington Northern Santa Fe, CSX Transportation, and the Norfolk Southern, told industry analysts in a series of conference calls in mid-October that they'd experienced a significant, double-digit increase in profits at a time when it appeared much of the rest of the American economy was tumbling all around them.

But as the financial crisis deepened in the days before those calls, becoming truly global in nature and touching off a renewed period of supply chain upheaval, the nation's Class 1's looked to be in for a somewhat bumpier ride, at least in the foreseeable future.

A score of factors, ranging from restive shippers to renewed calls for stripping them of their antitrust exemption to projections that the current economic woes will ultimately give way to a need for a doubling of current rail capacity within the next 25 years suggest the railroads' historic resilience may soon be tested.

A little history

How one feels about the state of the rail industry today isn't only a matter of what side of the customer/provider divide one sits on. It is also largely dependent on what time frame one is willing to consider in his analysis.

Advocates for the railroad industry, for instance, will

The Congresswoman Who Wants to Undo the U.S. Rail "Monopoly"

Rep. Tammy Baldwin didn't expect to take on the titans of the railroad industry when she was first elected to Congress in November 1998.

The first Wisconsin woman ever to be elected to the House, her passion was striving to pass legislation for universal health care.

But shortly before being elected to her fifth term in 2006, Baldwin told World Trade, constituents began to unburden themselves of their concerns about the rail industry and the effects it was having on her state.

By far the most jaw-dropping story came from the Dairyland Power Cooperative, an electric power distributor, in Lacrosse, just outside of her district's boundary.

"They were long time recipients of coal shipments, but were captive to one rail company, and had been told at the end of 2005 that their rates would nearly double," Baldwin said. "As a result, while they were still shipping $30 million worth of coal annually, it was going to cost them $75 million a year to receive it."

As a consequence of the new rates, the utility was forced to pass along its own rate increase to its half million customers. There was an additional rub to the story, however. On top of exorbitant rates, the utility was also forced to contend with inadequate service from its rail provider, and that led frequently led to its own customers paying more for less reliable electricity.

Baldwin's response was to introduce the Freight Railroad Antitrust Enforcement Act of 2007, which seeks to create more competition and remove anti-trust exemptions granted to the railroad industry under the Stagger's Rail Act of 1980.

"As far as I'm concerned, it's vital to me state that we begin to end the railroad monopolies that are driving consumer prices up and service down," she said. "After all, when it comes to rail, our companies and utilities don't have an option of shopping elsewhere down the road."

Since 2005, Baldwin said, the rates consumers pay for electricity in Wisconsin have increased 15 percent to 20 percent, and businesses ranging from restaurants to dry cleaners have been forced to pass the higher rates they've been paying along to their customers.

Baldwin said her bill and a similar proposal in the U.S. Senate—sponsored by Wisconsin Sen. Herb Kohl—would empower the Justice Department and the Federal Trade Commission to review future railroad mergers and take definitive steps against the paper barriers that shippers say bound them to a single carrier even when a short line rail they utilize gives them theoretical access to another.

"If you are a manufacturer or a business with transportation needs and you're looking at where to locate a new plant or facility, the question of whether or not you're going to be captive to one rail carrier is obviously something you'll have to consider," Baldwin added.

"The freight rail companies certainly don't like the bill and have been a vocal lobby in Washington against it, but what occurred, overtly, has been kind of interesting," she said. "Instead of focusing on my bill, they've invested in a public media campaign talking about how wonderful freight rail is and focused it heavily on the D.C. market, where they know legislators will see it."

"On the one hand, they say that if antitrust laws are applied to them, it will destroy their industry," she said. "On the other hand, they also ask lawmakers, 'Why are you doing this? It won't really change anything.'"

Even Baldwin conceded she's unsure whether her bill will amount to anything or not.

"I'd love to see it passed in the remaining time as a stand alone, but given the talk of another economic stimulus bill that might include some infrastructure spending, I might try to attach it as an amendment there."

point out that from the mid-1980s through 2000, rail rates actually consistently went down. From their perspective, rates "stabilized" around 2001, and then from about 2003 through 2007 climbed at an annual rate of no less than 6 percent.

What set the roller coaster ride in motion?

To begin with, there was the federal Stagger's Act of 1980, which directed the Interstate Commerce Commission to deregulate a then-moribund rail industry—an industry still reeling from the creation of the interstate highway system in the 1950s and the resulting ascendance of interstate trucking.

"Remember, we were in pretty bad shape at the time," said Tom White, spokesman for the Association of American Railroads. "We had to react to competitive forces in the marketplace, which, just as today not only included other railroads, but also the trucking industry, and, in some parts of the country, barge service."

As part of that reaction, the railroads also began to make strides in improving their competitive footing through advances in productivity.

One method was through the employment of unit trains—building trains intended to carry a single product, like coal from the Powder River Basin in Wyoming, to a single destination, in this case a coal-fired power plant—another was double-stacking, which quickly took hold as the preferred mode of rail shipment in the western United States and is now beginning to proliferate along the eastern seaboard.

The liberalization of federal regulations also simplified the process of abandoning unproductive rail lines to Class 2 or Class 3 railroads, whose cost structures made the lines more economical than they had been for their original owners.

By the time Congress abolished the Interstate Commerce Commission in 1995, replacing it with the Surface Transportation Board, the body that now considers railroad rate and service disputes and reviews proposed railroad mergers, the context for all these changes had dramatically changed.

Railroad advocates contend rail rates began to rise appreciably only after the Class 1's had run through the

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most readily achievable productivity changes and the cost of fuel began to rise.

Others suggest the upward pressure on prices was more directly the result of import surge from China that began in the mid-1990s. As capacity began more constrained by the largely unanticipated bounty of goods pouring through U.S. ports, railroads were forced to ration capacity in reaction to a growing scarcity of rail cars and free track space.

Less capacity meant higher prices paid for the precious capacity that was left.

Still others contend the rapidly escalating cost of transporting foods and materials by rail over the past decade has simply been an exercise in market power.

Rail has always had a marked advantage over long-haul trucking in terms of fuel efficiency—trains get well in excess of 400 miles per gallon of diesel on average, three times more fuel efficient than trucks.

"People have described the last few years as a rail renaissance, and I think that's an apt description,' White said.

But the railroad association spokesman hastened to add that the current "economic dislocation" is having an effect.

Jim Damman, the former railroad man who is now president of 3PL Exel Transportation Services agrees.

"Railroads have been pretty aggressive on raising prices for the past five years, but [last year] was a little different," said Damman, who spent 19 years with the Union Pacific railroad before joining Exel.

Three or four years ago, he said, capacity was a problem because the railroads were struggling to put "more traffic on rail than they had demonstrated they had a capacity to move."

"Right now, that isn't as much of an issue for us," Damman said. "That's largely due to the freight recession we've been in since 2006, with freight slowing as the economy slowed."

"I think that's definitely tempered their aggressiveness on prices; on the other hand, they haven't backed off on the prices they had in place before the slowdown began," he said.

Nor do they plan to.

During CSX's recent conference call with industry analysts, Clarence Gooden, the company's chief sales and marketing officer, was firm. "We intend to maintain our pricing discipline," he said. "We're not going to give up the discipline that we've established over the last four years on an economic whim."

Bob Szabo, executive director of Consumers United for Rail Equity, a coalition of freight rail customers seeking more competition among the nation's railroads, said the problem with the Class 1's is that they've been allowed to largely operate as monopolies for more than a quarter century.

"Where we have competition, we're happy," said Szabo, whose group is comprised of large trade organizations representing more than 3,500 electric, utility, chemical, manufacturing and forest and paper companies.

"But where we don't…Well, that's another story," he said. "The problem is they then went on and established regional monopolies," he added.

The crux of his complaint is that the government's primary concern has always been watching out for predatory acts between railroads.

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"They felt as long as shippers were similarly situated, they weren't disadvantaged," he contends.

Szabo said the unintended consequences of such a view—consequences deepened by deregulation—was that the federal government failed to see that some shippers—those who were effectively "captive' to one service provider—were disadvantaged by the realities of the industry.

"You see, one of the presumptions Congress made back in 1980 was that if you got government out of the way, the railroads would develop the system the nation needs," he said.

"The reality is that when you get government out of the way, railroads will develop the system they need to maximize profits"

He contends that many shippers assumed that if the new short line rail roads that took over many of these lines crossed the tracks belonging to multiple Class 1 railroads, they'd have a choice of who to ship with.

In reality, the contracts leasing the tracks to the short lines effectively prohibited the shippers from doing business with anyone but them.

"In anti-trust language this is considered a paper barrier," Szabo said. "There's no physical barrier to your using a competing rail line, but the financial constraints are such that you have no choice."

Adding insult to injury, he said, is that as the railroads have become more powerful, they've shifted an increasing amount of their costs onto the shippers.

This past summer's fuel surcharges are one example, but Szabo said shippers have also been forced to bear the costs for additional rail cars and of creating additional sidings and loading facilities.

Equally galling to critics of the freight rail industry was the Surface Transportation Board's ruling—later upheld by the 8th U.S. Circuit Court of Appeals—of what is commonly referred to as "the bottleneck case."

Because of the long distance nature of freight moves by rail, it is often necessary for more than one railroad to provide interline service from origin to destination, and in such cases the shipper is charged a joint or proportional rate.

In the Bottleneck case, shippers wanted to break up through-movements into pieces so they could combine a rate for the shorter, bottleneck portion with a rate set by head-to-head competition for the longer non-bottleneck segment.

In 1999, the Surface Transportation Board sided with the railroads and that decision has stuck ever since.

Steven Eames, who heads up the U.S. arm of Dubai-based Jafza International, which is now building its first logistics park in North America on 1,300 acres in central South Carolina, also believes the free market will not deliver the rail the country currently needs.

"The free market worked a century ago as rail helped the United States expand westward, but today access to ports and short track opportunities are used by Class 1 railroads to exclude their competitors," he said.

To break the monopoly, Eames suggested that quasi-state entities like the Virginia Port authority or South Carolina Public Rail take over short track and switching operations near their respective ports.

"These short rail operations would be expensive, and would necessarily have to be subsidized by the government and the ports to be competitive, but they would allow for an equal handoff to the long haul Class 1 rails for market access using their different networks," he said.

In an effort to achieve at least a measure of these aims, Consumers United for Rail Equity (CURE) is supporting Baldwin's effort to re-regulate the railroads, and a second bill that would revamp the surface transportation board, making it more proactive in its supervision of railroads, particularly when it comes to setting rates.

But to Tom White, assertions that the railroad's are not covered by federal anti-trust legislation is "pure fiction."

"The industry is as prohibited from collusion in setting rates and otherwise restraining trade as anyone else," he said. "The only type of exemption that exists is in cases where two railroads do a joint move, and that so that the customer doesn't effectively pay twice for the same move."

A breather from the cargo surge, but only a breather

Despite the current economic headwinds associated with the recent financial meltdown, U.S. freight volumes are still expected to double within a generation.

As a result, states a September report by the nonprofit Rand Corporation, entitled The State of U.S. Railroads, a commensurate increase in the reliance on rail is a way to minimize congestion on the nation's interstate highway system

The problem said the study, which was supported by the UPS Foundation and conducted under the auspices of the RAND Supply Chain Policy Center, is that the nation's rail system has contracted dramatically over the past several decades, resulting in additional concerns about congestion and the system's being incapable of handling the additional volume.

White said current estimates suggest the cost of that additional capacity could loom as high as $135 billion, while the nation's Class 1 railroads would likely only be able to generate about $96 billion of the cost.

"If you do the math, it's critical that we get started building capacity today, because it takes a lot of time and money to do that," Damman said.

To accommodate the forecasted growth in freight demand, Jazfa's Eames insists a strategic, planned and appropriate investment in freight infrastructure is a necessity. The problem, he said, is that while "everyone is talking about rail," they're doing so without really understanding the reality of rail in the U.S.

In addition, he said, the rhetoric surrounding the debate, "Is still very monopolistic and anti-central planning due to the special interests of the rail companies."

"Where we have competition, we're happy. But where we don't, that's another story."

–Bob Szabo, Executive Director, Consumers United for Rail Equity

Mandates

The need to create this new capacity can't be addressed in a governmental policy vacuum. But, railroad leaders find the prospects of federal direction unappealing, to say the least.

Michael Ward, CSX's chairman, president and chief executive officer, raises the specter of re-re-regulation. "If anything, I think the biggest risk to sustaining capital expenditures….would be if there were some sort of regulatory change, like a re-regulation, that might choke the expansion…because we would obviously have to reevaluate our investment criteria at that point." Instead, Ward calls for supporting rail investment through tax credits and public/private partnerships.

Eames dismisses such reservations as self-serving.

"The choice of investment in infrastructure is like any other investment decision we make," he said. "Do we invest for the short-term or long term benefit of coming generations? A piecemeal, disjointed approach to a freight transport system today adds to our burdens tomorrow."

"At some point, someone will have to stand up to the cause of properly equipping our nation for participation in global economy. Given the capacity and constraints that loom on the horizon, the time is now," Eames said.

Among the railroads, optimism remains

On top of all these issues, the nation's railroads enter the new year still dealing with the lingering effects of hurricanes Gustav and Ike, which knocked out service to New Orleans for five weeks and led to interchange traffic being rerouted through other gateways, including St. Louis, Memphis and Birmingham.

These re-routes, coupled with heavy rains and flooding in the Midwest, caused congestion in some terminals and impacted freight flow by increasing dwell times for some cargo.

Those events also gave something of a boost to the trucking industry, which during the period could aptly promote itself not only as the only way to go for the last mile of a delivery, but also as a much faster way to go.

Trucking advocates have been actively promoting the introduction of a provision to the federal highway reauthorization bill, which would increase the size and trailer length of cargo-hauling trucks.

Yet in their conference calls with analysts last October, rail executives sounded little concerned about the competitive threat from trucking. "In the future, the transportation outlook favors rail not only because we offer the most efficient way to move products, but also because rails take traffic off the highways, reduce fuel consumption and help the environment," Michael Ward said.

Meanwhile, Union Pacific Corp. CEO James Young predicted that, despite the weak economy, there would be "low double-digit" earnings growth for 2009.

As for Norfolk Southern, CEO Wick Moorman said the railroad's strong third quarter revenue performance demonstrated, "the strength of our diversified traffic base." However, Moorman also suggested that if the economy continues to deteriorate, Norfolk Southern is prepared to begin to cut spending.

"If the economy changes, we'll go in and cut expenses where we can, and there are places we can do that," he said. Until then, "We believe the most appropriate way to run the company is to maintain a steady state of expenses in terms of our maintenance, our properties, our infrastructure, our assets and investments."

"While we are all concerned about the current financial and economic situation," said Mathew Rose, chairman, president and chief executive officer of the Burlington Northern Santa Fe Corporation, seemingly speaking for all his rail brethren, "we continue to be optimistic about the future of our diverse franchise and we remain confident about our long-tem prospects." **WT**

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