

Testimony of

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Introduction

My name is Curtis M. Grimm, and I am Dean's Professor of Supply Chain and Strategy, Robert H. Smith School of Business, University of Maryland at College Park. I have been a member of this College since 1983. I received my B.A. in economics from the University of Wisconsin-Madison in 1975 and my Ph.D. in economics from the University of California-Berkeley in 1983. My Ph.D. dissertation investigated competitive impacts of railroad mergers.

In my background, I have extensively addressed public policy issues regarding transportation. I have previously been employed by the Wisconsin Department of Transportation, the U.S. Interstate Commerce Commission, and the Australian Bureau of Transport and Communication Economics, and I have provided consulting services to several other government agencies and private firms regarding transportation issues. I served as Assistant to the Chief of Intercity Transport Development, Planning Division, Wisconsin Department of Transportation in two separate stints between 1975 and 1978, with a focus on rail policy issues such as abandonments and the creation of shortline railroads. While serving as an economist at the ICC's Office of Policy Analysis from January to December 1981, my duties included analysis of competitive effects for the Union Pacific-Missouri Pacific-Western Pacific ("UP-MP-WP") merger.¹ During 1982, I served as a consultant for the Commission while the UP-MP-WP decision was being drafted and subsequently consulted for the ICC with regard to the Ex Parte No. 347 decision ("Coal Rate Guidelines - Nationwide").²

¹ Union Pacific Corporation, et al., -- control – Missouri Pacific Corporation and Missouri Pacific Railroad Co., Finance docket No. 30,000, 366 I.C.C. (ICC decided September 24, 1982).

² Coal Rate Guidelines, Nationwide, 1 I.C.C. 2d 520 (1985), aff'd sub nom., Consolidated Rail

I have subsequently participated in several ICC and STB proceedings, including rate cases and a number of rail mergers, with a focus on the competitive consequences of these transactions. On November 8, 1995, I provided testimony regarding competitive issues in rail mergers to a Joint Meeting of the United States Senate and House of Representatives Committees on Small Business.

My research has involved deregulation, competition policy, competitive interaction and management strategy, with a strong focus on transportation. This research has resulted in over 80 publications, including articles in leading journals such as Journal of Law and Economics, Transportation Research, Transportation Journal, Logistics and Transportation Review, Academy of Management Journal, Management Science, Strategic Management Journal, and Management Science. More than two dozen publications have dealt specifically with the railroad industry, mainly on economic and public policy issues. I have also co-authored four monographs, including *The Economic Effects of Surface Freight Transportation* (1990) with Cliff Winston, Thomas Corsi, and Carol Evans.

In summary, I have had extensive experience over almost 30 years on rail policy issues. I am very pleased to have the opportunity today to provide input on this important issue and would like to make clear that I am not testifying on behalf of any group or organization. My purpose is to draw on my experience to provide views on several overarching issues with regard to the current regulatory environment on railroads and shippers, and to provide information from the research I've conducted in this area. I can summarize my position as follows: The Staggers Act has substituted market competition for government regulation across much of the rail industry. This deregulation has

resulted in substantial benefits to the railroads and to many rail shippers. Policymakers can preserve and extend the benefits of deregulation by increasing the level of rail competition; particularly important is to provide rail competition to captive rail shippers wherever feasible.

Railroads play a vital role in our nation's economy

Railroads are and will continue to be an essential component of our nation's transportation system. As highway congestion worsens over time, railroads become even more vital. Railroads also have advantages over other modes with regard to energy efficiency and safety. Clearly, public policy should facilitate a strong and healthy railroad industry.

Railroad deregulation was designed to improve the health of the railroad industry.

The U.S. railroad industry was largely deregulated because of its poor financial performance under regulation. Rail's ton-mile share of the U.S. intercity surface freight market declined from 65 percent to 35 percent in the post-WWII decades.³ Correspondingly, most major railroads' returns on investment were very poor.⁴ After a number of railroad bankruptcies in the early to mid 1970s, partial deregulation began under the Railroad Revitalization and Regulatory Reform (4R) Act of 1976. The 1980 Staggers Act further deregulated the industry.

³ Robert E. Gallamore, "Regulation and Innovation: Lessons from the American Railroad Industry," in Jose Gomez-Ibanez, William B. Tye, and Clifford Winston, editors, *Essays in Transportation Economics and Policy: A Handbook in Honor of John R. Meyer* (Brookings, 1999).

⁴ Theodore E. Keeler, *Railroads, Freight, and Public Policy* (Brookings, 1983).

Railroad deregulation has had positive impacts on the rail industry because it substituted competition for government regulation for most rail customers.

U.S. rail deregulation provided a greater reliance on free markets to promote railroad profitability and public benefits. By increasing operating freedom and stimulating competition, deregulation spurred the railroad industry to shrink its physical plant and work force to better match available traffic.⁵ As discussed by Grimm and Winston (2000): “The industry abandoned roughly one-third of its track and reduced crew sizes; used contracts to align cars and equipment with shippers’ demand and to reduce its vulnerability to problems caused by overcapacity; and expanded the use of intermodal operations, double stack rail cars, and computer systems to provide faster, more reliable service. Real operating costs per ton-mile have fallen steadily, and, as of 1998, were 60 percent lower than when deregulation began. Some of the cost decline can be attributed to the long-run trend in rail’s traffic mix to include a greater proportion of low-cost bulk traffic, but deregulation’s contribution is substantial.

Cost reductions and productivity improvements stemmed the long-run erosion in market share. And rail traffic grew. After reaching a post-war low in the mid-1980s, originating rail carloads have grown from 19.5 million in 1985 to 25.7 million in 1998.⁶ All of these factors have boosted profitability. During 1971-80, the industry’s return on

⁵ This section draws from Curtis M. Grimm and Clifford Winston, “Competition in the Deregulated Railroad Industry: Sources, Effects and Policy Issues,” in Sam Peltzman, editors, *Deregulation of Network Industries* (Brookings, 2000), and Curtis M. Grimm and Robert Windle, “The Rationale for Deregulation,” in James Peoples, editor, *Regulatory Reform and Labor Markets* (Kluwer Press, 1999).

⁶ Association of American Railroads, *Railroad Facts*, 1999 edition, p. 24.

equity was less than 3 percent; during the 1990s the industry's return on equity averaged 10.7 percent.⁷” Rail deregulation has clearly been a successful policy; however, there are two salient issues that deserve attention by policymakers.

Issue 1: In the aftermath of the 1990s rail merger wave, the industry is now dominated by four large carriers.

Rail mergers since the Staggers Act have occurred in waves. As discussed by Grimm and Winston (2000), in the early 1980s, Chessie System and Seaboard Coast Line formed CSX, Norfolk and Western and Southern Railroad formed Norfolk Southern, Missouri Pacific and Western Pacific became part of Union Pacific, and the St. Louis-San Francisco Railroad along with Colorado Southern and Fort Worth Denver formed part of Burlington Northern. The next merger wave began in the mid-1990s. The Burlington Northern-Santa Fe and Union Pacific-Southern Pacific mergers left only two major railroads in the western United States while Norfolk Southern's and CSX's joint acquisition of Conrail left only two major railroads in the east. These four railroads now dwarf smaller Class I's, regional railroads, and short line railroads in the U.S. Operating revenues in 2001 for these four were: Union Pacific - \$10.6 billion; BN - \$9.2 billion; CSX - \$6.4 billion, and NS - \$6.1 billion. All other railroads in the U.S. have annual revenues well under \$1 billion. (Extending the view north of the border, Canadian National has annual revenues of \$3.6 billion, while Canadian Pacific has annual revenues of \$2.3 billion.) This size disparity has created a competitive imbalance amongst U.S.

⁷ United States General Accounting Office, *Railroad Regulation: Changes in Railroad Rates and Service Quality Since 1990*, April 1999.

railroads, in many cases limiting the ability of the smaller railroads to provide effective competition.

Issue 2: Approximately 20% of rail customers are captive to a single railroad and do not have effective competition from other modes.

While many rail shippers have benefited from the competition unleashed by the Staggers Act, a small but important customer segment of captive shippers remains. An example would be a shipper of coal where a utility is located on just one railroad. Work I have done co-authored with Cliff Winston of Brookings estimates that approximately 20% of shippers are captive, and that captive shippers pay on average 20.9 percent higher rates. Multiplying the total captive traffic times the 20.9 percent rate differential, we found that the total transfer from captive shippers to railroads is about \$1.3 billion on an annual basis.⁸

Solution: Empower smaller railroads and provide competition to captive shippers.

Effective remedies to address the captive shipper issue and empower smaller railroads are readily at hand. A variety of means are available to accomplish these dual objectives in a manner that could be implemented with little administrative burden. For example, removal of “paper barriers” to competition between major railroads involving short line and regional carriers would increase their competitive vitality and provide meaningful competition for many captive shippers. Requiring railroads, particularly the four large ones, to quote rates to points of competition would be a positive step.

⁸ Curtis M. Grimm and Clifford Winston, “Competition in the Deregulated Railroad Industry: Sources, Effects and Policy Issues,” in Sam Peltzman, editors, *Deregulation of Network Industries* (Brookings, 2000).

Mandatory interswitching within a prescribed radius, as has been practiced in Canada since 1908, also merits consideration. Access could be provided asymmetrically with respect to railroad size to both strengthen the smaller railroads and provide relief to captive shippers.

New legislation to stimulate competition would extend the success of the Staggers Act

Why was the Staggers Act successful? Railroad deregulation has had positive impacts on the rail industry because it substituted competition for government regulation for most rail customers. Staggers stimulated competition and gave the railroads freedom to compete. When faced with new competition, railroads cut costs, increased productivity and improved service quality. Additional moves to increase rail competition will further strengthen the industry. Competition provides a built-in accountability mechanism. Firms and managers who are best able to compete by cutting costs and improving service will emerge with a more prominent role in the industry.

The railroad industry will not lose its ability to invest in infrastructure, as has been asserted. The starting point for delineating an upper limit on rail revenue diminution is the \$1.3 billion differential between captive and competitive shippers. However, the measures now contemplated would only provide partial competition to some of the captive shippers. So the expected rail revenue losses are well below \$1.3 billion, even before we factor in the competitive response of railroads to cut costs and increase productivity. Also, traffic would be drawn from other modes if rail rates were reduced as a result of additional intra-rail competition.

Concern about potential short-term rail revenue diminution is no reason to accept the status quo. Policy makers could dovetail increased competition for captive shippers

with financial assistance for railroads in the form of infrastructure grants or tax policy changes. Both of these options have been proposed, but not yet linked to the captive shipper issue. I'm sympathetic to railroad industry arguments that other modes are unfairly subsidized to the detriment of rail. Let's level both playing fields. Couple assistance to rail with competitive relief for captive shippers. Two wrongs don't make a right, but correcting these two wrongs simultaneously is the right policy direction.

Addressing the captive shipper issue will strengthen the rail industry by mitigating railroad/shipper tensions.

Resolving the captive shipper issue will ease railroad/shipper tensions. It's not healthy for the railroad industry to be at war with its best customers year in and year out. Resolution of the captive shipper issue would allow shippers and railroads to focus on achieving logistics efficiencies as partners. Today, these mutually beneficial supply chain collaborations are far more prevalent between shippers and trucking firms, where economic deregulation is complete.

Extending competition to captive shippers would be deregulation, not re-regulation.

Railroads have consistently characterized legislative changes such as embodied in the Railroad Competition Act of 2003 as "re-regulation. This is clearly a misnomer. The core of remaining STB regulation involves the determination of maximum rates for captive shippers. Reducing the number of captive shippers and concomitantly reducing the purview of the STB would further *deregulate* not -- *re-regulate* -- the rail industry. And this would have the added benefit of easing the excessive STB workload.

Conclusion

Rail deregulation, now 80% complete, has clearly been a success. Policy makers should move further down the deregulatory road by extending competition wherever feasible to captive shippers. Shippers and railroads should be encouraged to work together on a win-win solution to this issue, with public financial assistance potentially a part of the package. Addressing the captive shipper issue is essential if railroads are to continue their vital role in our nation's economy.