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Given at a Surface Transportation and Merchant Marine Hearing:  
**Railroad Shipper Issues and S. 919, the Railroad Competition Act of 2003**  
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The Testimony of  
**The Honorable Roger Nober**  
 Chairman, Surface Transportation Board

Good morning, Chairman Hutchison, Ranking Member Inouye, and Members of the Subcommittee. My name is Roger Nober, and I am Chairman of the Surface Transportation Board. I appreciate the opportunity to appear before this Subcommittee today to discuss the rate and service issues faced by railroad shippers in general and singly-served (otherwise known as "captive") rail shippers in particular, and the provisions contained in S. 919, the Railroad Competition Act of 2003. This is my first appearance before this Subcommittee as Chairman of the STB. I appreciate the longstanding and deep interest that the Members have shown in the issues facing the railroad industry, which are vitally important to the financial health of the freight railroads, to the railroads' customers and employees and to the nation's freight transportation system as a whole. I commend the Subcommittee for holding this hearing and discussing these important issues. In my written testimony, I would first like to provide the Subcommittee with an overview of the Board and its responsibilities. Next, I will discuss steps the Board is taking to address issues faced by singly-served or captive shippers. Finally, I will discuss S. 919. Overview of the STB As all of you know, the Surface Transportation Board was created eight years ago by this Committee in the ICC Termination Act of 1995. The Board is an economic regulatory agency that Congress charged with the fundamental missions of resolving railroad rate and service disputes and reviewing railroad mergers, line sales, abandonments and new construction. Structurally, the Congress determined that the Board should be decisionally independent but administratively affiliated with the Department of Transportation. When it was created at the beginning of 1996, the Board had to accomplish its statutory missions with one-third fewer employees than had been performing those same functions at the ICC. Since 1996, the Board has met its statutory deadlines while functioning with nearly the same level of resources during that time. But as I will outline in my testimony, the Board will face new challenges in the coming year as it works to address the issues raised today and will need some modest additional resources to continue its important work. The Board serves as both an adjudicatory and a regulatory body. The Board has jurisdiction over railroad rate and service issues and rail restructuring transactions (mergers, line sales, line construction, and line abandonments); certain trucking company, moving van, and non-contiguous ocean shipping company rate matters; certain intercity passenger bus company structure, financial, and operational matters; and certain pipeline matters not regulated by the Federal Energy Regulatory Commission. In sum, when Congress eliminated the ICC in 1995, it created the Board to carry out two core functions – reviewing merger proposals and resolving disputes over rates and services provided by railroads. One of the main reasons the Board exists is to provide a regulatory backstop to assess the reasonableness of rates charged to captive shippers when those customers and their railroads are unable to successfully negotiate a contract for the transportation. The Board has created a number of mechanisms to help railroads and their customers resolve disputes before availing themselves of the Board's formal processes. For example, the Office of Compliance and Enforcement operates the Rail Consumer Assistance Program. That program is intended to provide assistance to rail consumers in addressing those issues that have not been resolved through private negotiations. When informal processes like that one cannot produce a solution, however, the Board must be the regulatory backstop that Congress intended it to be. It is no secret that many captive shippers – the focus of today's hearing – believe the Board has inadequately performed this core mission of ensuring that they have a forum for reaching a formal resolution of rate or service disputes. They feel that without a regulatory backstop, the transportation market for freight rail services does not properly function. Many of the issues they raise are legitimate, and I will next turn to the fundamental concerns raised by captive shippers and the steps the Board is taking to address them.

Issues Faced by Captive Shippers 1. Unreasonable Rates Under the Interstate Commerce Act, the Board has exclusive jurisdiction to resolve rate disputes in those instances when railroads have market dominance – in other words, the railroad is charging a rate higher than the regulatory floor and the shipper has no effective transportation alternative. Under the Interstate Commerce Act, the Board must balance the often conflicting objectives of assisting railroads in attaining revenue adequacy, on the one hand, and ensuring that the rates that individual shippers pay are reasonable and fair, on the other. The balance, as we all know, is not an easy one. Rates that are too high can harm rail-dependent businesses, while rates that are held down too low will deprive railroads of revenues to pay for the infrastructure investments needed to give shippers the level and quality of service that they require. The Board is the forum of last resort if a captive shipper feels his rate is unreasonable, and the agency must do its best to carry out the law in a way that is fair to all when deciding railroad rate cases. The Board has one set of procedures for handling "large" rate cases and another for "small" cases. In recent years, the Board has experienced a

significant increase in the number of large rail rate complaints filed with it. Whereas in past years the Board had two or three of these cases pending at any one time, today it has 13 large rail rate disputes pending (as well as two pipeline rate disputes and two water carrier rate disputes pending). The Board still has not had a single small rate case filed since it adopted its small case guidelines in 1996, but as I will discuss further, my top priority for the next year is to establish a meaningful process for quickly and surely deciding small rate cases. a. Large Rate Cases. Determining the reasonableness of a rate in a large rate case is a complicated inquiry. The Board's governing statute requires it first to determine whether the railroad has monopoly power over its customer – in other words, whether the railroad is market dominant. Only if the railroad is market dominant does the Board have jurisdiction to review the rate. This is so because Congress has foreclosed rate regulation where there is effective competition. Once it has determined that it has jurisdiction to review the rate, the Board applies a court-approved methodology for rate review known as “constrained market pricing” (CMP).

i. Market Dominance. The first step in a rate case is a two-part inquiry to determine whether the railroad has “market dominance” over the transportation to which the rate applies. The first part is to determine the “variable costs” of providing the service. The statute establishes a conclusive presumption that a railroad does not have market dominance over transportation if the rate that it charges produces revenues below 180% of the variable costs of providing the service, which means that this 180% revenue-to-variable cost (r/vc) percentage is the floor for regulatory scrutiny. If the rate the railroad charges exceeds the 180% r/vc threshold, the second part of a market dominance inquiry involves a qualitative assessment in which the Board must determine whether there are any feasible transportation alternatives that could be used for the traffic involved. The Board considers whether there is actual or potential direct competition – that is either competition from other railroads (intramodal competition) or from other modes of transportation such as trucks, pipelines, or barges (intermodal competition) for transporting the same traffic moving between the same points. If there are effective competitive alternatives for the transportation, then the Board does not have jurisdiction to regulate the rate, even if the rate charged yields an r/vc ratio greater than 180%. ii. Rate Reasonableness Standards. If the shipper can show that the railroad is market dominant, then the Board applies its CMP principles to assess whether the rate being charged that shipper is in fact unreasonable. CMP provides a framework for the Board to regulate rates while affording railroads the opportunity to cover their costs. It is premised on differential pricing, that is, pricing based on the demand for the service provided. CMP principles recognize that, in order for railroads to earn adequate revenues, they need the flexibility to charge different customers different prices based on each customer's demand for rail service. But CMP principles also impose constraints on a railroad's ability to price. Despite the complexity of CMP, the courts have held that it is the most desirable available approach to railroad rate review and that the Board must use it whenever it is feasible. Although complaining shippers can choose from three approaches, the most commonly used CMP constraint is the “stand-alone cost” (SAC) test. Under SAC, a railroad may not charge a shipper more than what a hypothetical new, optimally-efficient carrier would need to charge the complaining shipper if such a carrier were to design, build, and operate – with no legal or financial barriers to entry into or exit from the industry – a system to serve only that shipper and whatever group of traffic that shipper selects to be included in the traffic base. The ultimate objective of the SAC test is to ensure that the complaining shipper is not charged for carrier inefficiencies or for facilities or services from which the shipper derives no benefit. As with CMP in general, this assures the complaining shipper that it is not required to pay for inefficiencies or to unfairly subsidize other customers of the railroad. iii. The Board Is Working to Reform the Large Rate Case Process. Deciding large rate cases is time consuming and costly for both the parties involved and the Board. Although the Board by statute has 9 months after all evidence is filed to decide a large rate case, it can take more than twice that long after the shipper files its complaint for the parties to file all their evidence with the Board. Preparing that evidence and presenting it to the Board are very expensive – parties have testified that a SAC case can cost as much as \$3 million to prosecute, \$5 million to defend, and generate more than 700,000 pages of material. When I became Chairman, the Board intensified its search for ways to simplify and speed up this process, and as a result of this effort the Board recently adopted a number of changes to its rules. Last February the Board held a hearing in the rulemaking proceeding entitled Procedures to Expedite Resolution of Rail Rate Challenges To Be Considered Under the Stand-Alone Cost Methodology, STB Ex Parte No. 638, which was exceptionally productive. Based on the extensive testimony received from shippers and railroads, in April the Board revised its rules in ways that ought to both shorten the decisional process and limit the expense of bringing a case. The new rules' most significant provisions include: (1) mandatory, non-binding mediation at the beginning of the case, under the Board's auspices, between the complaining shipper and the defendant railroad; (2) expedited procedures to resolve disputes, using Board staff, over what information the parties can be required to give to each other during “discovery”; (3) technical conferences to resolve, before the actual evidence is filed, certain factual disputes between the parties using the expertise of Board staff; and (4) requiring parties to submit versions of all filings with the Board that can be read by the opposing party and the public. These new rules have already been a success. A significant component of the new rules is to increase the involvement of Board staff in the process through technical conferences and regular meetings with the parties. The Board established technical conferences because the parties were spending time and attorney and consultant fees fighting about – and the Board was expending resources to resolve – technical matters over which there should be no dispute, such as the number of miles between a coal mine and a power plant. In the first technical conference (held in the “Otter Tail v. The Burlington Northern and Santa Fe Railway” case), disputes over 200 pieces of data were settled in just over an hour. In the past, these disputes would have led to protracted litigation that would have cost the parties thousands of dollars in fees and could have substantially slowed resolution of the case. Another major component of the new rules was the institution of a 60-day period of mediation at the start of any new case. All parties – railroads and shippers alike –

who testified at our February hearing on Ex Parte No. 638 thought mediation would be a useful tool to help them to resolve their rate disputes privately. The first case since the Board adopted these new rules, "AEP Texas North v. The Burlington Northern and Santa Fe Railway", was filed in August 2003, and I am pleased to say that I selected former Congressman John Thune to conduct the initial mediation. During his tenure on Capitol Hill, Congressman Thune served on the Committee on Transportation and Infrastructure, where he was actively involved in matters concerning railroads and their customers. He also served as the State Rail Commissioner in South Dakota. He understands the perspective of both railroads and shippers, and the involvement of a mediator in this matter will help the parties resolve the dispute. It is important that the process for resolving major rail rate disputes be open and fair, and every party must have an opportunity to make its case so that the Board will have a full grasp of the implications of any actions it takes. In that regard, on September 10, 2003, for the first time, the agency held an oral argument in an individual large rate case ("Duke Energy v. CSXT Transportation"). This session was a productive one both for the Board and for the parties, and we will continue to hold arguments, as appropriate, in future cases. One significant outgrowth of this focus on rate cases is that recently, as the Board was putting together a decision last week in "Duke Energy v. Norfolk Southern Railway," we realized that we needed to ask the parties to supplement the record, which was incomplete in one critical respect. The same issue arises in two other similar cases. The Board issued an order addressing this situation and is taking additional evidence in all three cases over a 3-week period. A decision in the first case, Duke Energy v. NS, will be issued by November 6, 2003. In sum, while major litigation such as large rate cases is expensive and slow, the Board has made progress in helping to ensure that the rate cases before it proceed faster, cheaper and better. I will make it a priority to continue to make more improvements in this area, and more progress is possible.

b. Small Rate Case Procedures Since I became Chairman, my top priority has been to provide shippers who have smaller rate disputes an effective forum for resolving such disputes. On April 22, 2003, the Board held an oral hearing on this matter where it received testimony from representatives of shippers, railroads, and unions. In sum, shippers raised the following concerns. First, shippers contend that the ambiguity of who would qualify to use the small rate case procedures is an insurmountable hurdle that has chilled them from bringing any cases before the Board. Shippers believe that the railroads would fight any shipper's claim that it is entitled to use the expedited procedures, thus tying up the shipper in extensive, expensive threshold litigation. This uncertainty appears to be a major reason why no cases have been brought under the small-case process. The Board can address this concern and bring some level of certainty to this issue by constructing a test that looks at the size of the shipper and the value of the case. If a shipper or its shipment met that test, the shipper automatically would be eligible to use the small case process. Second, shippers asked the Board to ensure the expedited consideration of small rate cases and to constrain the discovery process. These shippers argued that protracted resolution of small rate case disputes under our current rules does then no good because the transportation marketplace for such shipments is so fluid. Many shippers have suggested arbitration as a way of resolving such disputes because of its speed and simplicity. Railroads oppose arbitration, since those proceedings are outside of the strictures of the Interstate Commerce Act – which requires a balance between shippers' need for fair rates and railroads' need to achieve revenue adequacy – and could produce inconsistent results. While mandating binding arbitration is beyond the Board's statutory authority, I believe it is unnecessary because the small rate case process being developed should be able to accommodate each side's concerns. The Board can streamline the discovery and resolution process by creating an administrative process that combines the speed and simplicity of arbitration while ensuring that such cases are decided under the framework of the Interstate Commerce Act. One way for the Board to accomplish these goals is to hire an Administrative Law Judge (ALJ) to hear and decide small rate cases in the first instance. The ALJ would have a prescribed time period for overseeing discovery and for issuing a decision. The ALJ's decision could then be appealed to the full Board. This would allow cases to proceed with the speed and low cost of arbitration, but also ensure that these matters are decided under the principles of the Interstate Commerce Act. In fact, the Board is already working toward hiring an ALJ, and recently received approval to do so from the Office of Personnel Management. The hiring process will be completed once the Board's revised small case regulations are final. The Board could also establish, resources permitting, a Special Counsel to assist small shippers in evaluating and bringing a small rate case. The Board could also utilize the discovery and technical conferences now being used in large rate cases in small cases as well. Finally, shippers and railroads alike have urged the Board to adopt a rate standard for small cases that is clear, unambiguous, fair, and of course, able to withstand legal challenge. The Board promulgated a standard in 1996, but that standard has been widely criticized and – despite having never been applied – was challenged in Court (although the court declined to hear the challenge before the standard is actually applied in a case). Identifying an appropriate standard for the resolution of these cases is our greatest challenge, and while I have asked the parties to provide suggestions to the Board on revising the small-case standard, none has yet done so. After the hearing, I assembled a team from within the agency to meet with other economic regulatory agencies to gather information on how they handle smaller disputes. Our team talked with other agencies, including the Federal Energy Regulatory Commission, the Federal Communications Commission, the Postal Rate Commission, and the Maryland Public Utilities Commission, in a "best practices" survey to gather information that might inform our ideas. Unfortunately, the Board has not been able to move forward on this initiative. I have made a judgment that a rulemaking to create a new process for resolving small rate cases is significant enough that I should not take such action as a single Board member, even though I have the power to act alone. Although it is uncertain exactly how the Board's final proposal will look, I have outlined several key elements of the process and believe that these will form the core of meaningful reform.

2. Bringing Competition to Singly-Served Customers A common desire of singly-served rail customers is to gain service from a second, competing railroad. Singly-served rail customers who want to be served by a second railroad may work with that railroad to finance and apply for authority to construct a new rail line to the singly-served facility to gain rail competition. The Board's experience over the past decade has shown that new line construction can bring competition while

maintaining the private-sector characteristics of our rail system. The Board must take two regulatory steps before any such construction can occur. First, it must approve the addition to the rail network. Second, it must conduct any necessary environmental review of the project. The Board has worked hard to expedite consideration of requests to construct rail lines and to approve them when appropriate. The Board has recently been able to rule on two such proposals. First, the Board approved the construction by the Dakota, Minnesota and Eastern Railroad (DM&E) of a line into the Powder River Basin in Wyoming, which, if constructed, will provide enhanced rail transportation options for coal shippers, particularly in the Midwest. Second, the Board recently approved the construction of a line to provide BNSF access into the Bayport industrial area near Houston, which would provide competition to the large concentration of chemical companies located there. While build-ins can increase competition and provide many benefits, we have seen recently two examples that demonstrate that at times, the construction of new rail lines can be controversial in local areas. Indeed, both DM&E and Bayport Loop have generated extensive local opposition and spawned court challenges to the Board's decisions in those cases by various citizen and other groups. In DM&E, the United States Court of Appeals for the Eighth Circuit reviewed the Board's decision, and while the Court found the Board had done "a highly commendable and professional job," it nonetheless remanded the matter to the agency for limited additional consideration of a few environmental issues. We are still studying the Court's decision. The Bayport Loop case has produced litigation both in Federal court (where the Board's environmental review process is being challenged) and in state court (where the City of Houston is resisting the railroad's attempts to use state condemnation procedures to acquire property needed for the new line). Just last week, the state court in Texas delayed construction, but has yet to issue an opinion in the matter. Despite these two recent court decisions, the Board is confident that it will prevail in both of these cases. But notwithstanding the litigation that they can generate, construction projects represent the best way to balance the need for greater competition with the importance of preserving the private rail network. S. 919 Finally, I would like to address S. 919, the Railroad Competition Act of 2003. Taken as a whole, S. 919 would fundamentally change the economic model of the railroad industry and is unwise. Not a single one of our major railroads is revenue adequate, and if enacted, S. 919 would call into question the continued economic viability of our freight railroad system. While some shippers may realize a short-term gain from lower rates, in the long run this legislation, if passed, could significantly degrade our nation's freight rail network, to the detriment of all of its users. Although the nation's privately funded railroad system may have some problems, it is the best freight railroad system in the world, and the United States is the only country with a national freight rail network that does not need taxpayer subsidy. Most of the provisions of this legislation reflect unhappiness with the Board and certain of its regulatory doctrines. I have met with most of the supporters of this legislation, and they almost all agree that they would not be calling for this legislation if the Board had interpreted certain provisions of the Interstate Commerce Act differently. But the individual provisions in the bill are less significant than the underlying concerns that gave rise to the introduction of this legislation. Since I have become Chairman I have worked hard to understand the core concerns of captive shippers and the railroads that serve them. First, many shippers neither understand nor have confidence in the Board. My most important initiative as Chairman has been to win that confidence through openness and dialogue. During my nomination and confirmation process, there was a great deal of concern expressed about the lack of transparency at the STB. Since I have become Chairman I have taken several steps to change this perception, including restoring regular voting conferences on cases; holding hearings on significant matters such as large rate cases and small rate cases, and on individual cases pending before the Board such as the "Highline" case in New York and the "Kansas City Southern/Tex Mex" merger proposal; and most recently holding the Board's first ever oral argument on a large rate case. This summer, the Board also held an open house for practitioners to introduce our staff to them and explain how our agency processes cases. I have an open door policy for meetings and have met with many shippers and railroads. I have traveled extensively in the past year to better understand rail transportation. While these may seem like small steps, they have gone a long way to help our agency's stakeholders understand how and why the Board makes its decisions. Second, many disputes between shippers and railroads often take on a life of their own because of the way shippers feel they are treated by the railroads. Rail customers often conclude that while rates are high, the railroads' service and attitude are bigger problems. Rail customers are primarily wholesale enterprises who are themselves industrial and manufacturing companies or producers of goods. Like railroads, these shippers are capital intensive and work on thin profit margins. They have customers who demand top-notch service and low prices, and they have suppliers from whom they demand the same. All operate in a brutally competitive global marketplace. These companies understand the financial pressures railroads are under, but they feel that they are not treated by the railroads the way they would treat their own customers. This has led some shippers to assume that railroads act this way because they are monopolies and to believe that legislation like S. 919 would introduce more competition into the rail network and force railroads to be more responsive to them. Railroads should work harder to operate in a more customer-friendly fashion, and I am working with all of our major rail carriers to impress upon them the importance of doing so. Railroads must be nimble competitors in the transportation marketplace to increase their business and grow their revenues. While the leadership of each of the major railroads understands this, that attitude does not always translate through their entire organizations. The good news is that in many circumstances railroads have worked with their customers to improve efficiency and take costs out of the supply chain to the benefit of both parties. But these examples are not common enough, and they must become the norm, not the exception. Helping railroads improve their operations to provide better service is one goal that carriers, shippers and policy makers all share. The Board has been instrumental in bringing the railroads, the city and the state together to improve operations and devise a capital plan for improving operations in the Chicago terminal area. Approximately one-third of all rail shipments go through Chicago at some point in their journey. Improving Chicago and other rail gateways will allow for faster, more reliable shipments, to the benefit of all. Third, a fundamental underpinning of S. 919 is that very few rail shippers feel the Board provides an

effective regulatory forum in those instances when carriers and shippers cannot privately resolve their differences and the shipper has no effective recourse. Although the agency tries to help parties informally resolve their differences and improve relations between railroads and their customers, the Board has to be an effective regulatory backstop when a dispute over rates and services is formally brought before the Board. No cases have ever been brought under our small rate guidelines. This may be because there are no smaller rate disputes, or because there is something in the Board's rules that discourage shippers from bringing such cases. If no small cases are brought, this means that in practice, only about 75 coal shippers have a meaningful opportunity to challenge rail rates. This is unacceptable. At the same time, we must recognize that the economic relationship between shippers and carriers is complex. In many cases, shippers have many facilities – both captive and competitively served – and ship to numerous destinations on several railroads. While the legislation seeks to simplify the shipper-carrier relationship, in reality the relationships between shippers and carriers are enormously complicated and not easily understood. Many shippers do have economic leverage with railroads when the totality of their relationship is considered, and the legislation takes no account of this reality. A more accessible process for bringing small rate cases can be achieved through procedural reform at the Board, rather than through an overhaul of the substantive regulation of railroads. Real reform is possible, and the Board is working to identify the steps in the process that are the problems and develop reforms to address those problems. Finally, certain areas of the country are disproportionately dependent on rail service in general, and on a single rail carrier in particular, for its economic health. Many who are from the upper Midwest feel that, because of the importance of producing bulk, commodity-based products to their states' economies, their region's economies are particularly dependent upon the business practices of a single railroad. The Board must pay close attention to the unique set of concerns of rail shippers in that part of the country. I recently traveled to North Dakota and met with a number of government officials, shippers and producers. I have spoken numerous times with the railroad that primarily serves that area about the issues raised there. The issues faced in that part of the country are complex, and not easily solved. However, attention – and not legislation – is the best way to resolve the issues faced there, and while attention may not solve every problem, significant progress is possible. Conclusion One of my goals as Chairman of the STB has been to ensure that the agency's processes work as well as they can. The first step was to open up the Board. The Board has taken steps to streamline the process for large rate cases, steps which are already working. The Board will continue to reevaluate and refine how the parties and our staff work through the large rate cases. The next step is to improve the agency's small rate case process. I believe that the Board can and will do a better job to address the concerns raised by captive shippers. The reforms outlined today – and not substantive changes to the statutory scheme – are the best way to address the concerns raised by captive shippers while maintaining a healthy freight rail network. It is a difficult balance, but one that can be achieved. I appreciate the opportunity to discuss these issues today, and look forward to any questions you might have.

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