

PREPARED FOR CSX CORPORATION

# American Freight Rail Regulation

A Strategic Response

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NOTE: All graphs are sourced from the Association of American Railroads, Bureau of Labor Statistics, and Department of Transportation

## Executive Summary

From the beginning of America's freight rail industry in the 1830s, a critical debate among industry stakeholders has focused on the appropriate level of government oversight. Various regulatory regimes have emerged over the ensuing 180 years, influenced by changes in industry performance and external political forces. In the midst of a new era of debate, it is critical that industry stakeholders understand the forces behind — and implications of — regulatory change.

For carriers such as CSX Corporation (**CSX**), the current challenge is deciding how to respond to calls by shippers for regulatory change. Carriers have typically reacted to individual proposals in an effort to preserve the status quo, arguing that changes will threaten revenue adequacy and hasten a return to the 1970s — when roughly 20% of American rail was held in bankruptcy. Debates between carriers and “captive” shippers are frequently emotive. Both sides rely on analogy and anecdote to support their arguments, fueling competitive antagonism rather than strategic collaboration. This report considers the effectiveness of carriers' present approach to managing the regulatory debate and suggests an alternative approach to achieve greater long-term benefits.

### Chapter 1 Current Environment

Since the *Staggers Rail Act of 1980*, financial and operational outcomes for most industry participants have improved substantially. However, certain shippers have seen smaller rate improvements than their peers, and together with recent increases in aggregate rates, carrier profits, and service complaints, this asymmetric distribution has motivated the current debate.

As a pro-regulatory environment emerges in Washington D.C. in response to the global financial crisis, the chance that some of these proposals will be enacted has increased. This is a concern for carriers as the imposition of ill-conceived regulatory change may threaten their capacity to attract sufficient capital and make the investments necessary to meet projected freight demand. Even if these changes are not enacted, the debate reflects a short-term focus on competitiveness in the industry rather than a long-term focus on the competitiveness of the industry as part of broader national transportation strategy.

### Chapter 2 Industry structure

In determining how carriers should respond to this situation, it is critical to understand the industry's structure — its history, economics and stakeholders.

From a historical perspective, the industry is currently in a state of relative stability and equality. While the regulatory framework after World War II is viewed as having choked freight rail to a near demise, Staggers is seen as having revitalized the industry and set the stage for its current competitiveness. Given the difficulty of balancing the regulatory response to market failure with the financial health of carriers and shippers, current

legislators should recognize the risk that even small changes could upset a relatively equitable distribution of economic benefit and generate unintended costs.

In economic terms, the main issue is differential pricing, which is fundamental to sustain a privately-financed freight rail network but elicits criticism from those shippers subject to higher rates. Such demand-based rate setting is necessary to meet long-run costs, which can be above the marginal cost of service. Consequently, while shipper proposals to limit differential pricing may have short-term benefits for part of the network, those benefits may be outweighed by long-term costs to the whole network. In particular, proposals that limit price discretion may reduce the capacity of carriers to maintain and expand America's freight rail infrastructure to meet projected future demand.

Finally, interactions between and within stakeholder groups — carriers, shippers, labor, government, and the STB — have framed the regulatory debate. There is as much diversity within these groups as there is between groups, suggesting scope for cross-stakeholder cooperation in a non-legislative and non-partisan approach to resolving any outstanding issues.

### **Chapter 3 Strategic Response**

To ensure the long-term profitability, stability, and competitiveness of America's freight rail network, this report recommends that carriers shift away from the conventional approach of responding to individual regulatory challenges and towards an evidence-based, collaborative approach to designing a better regulatory framework. This approach would be consistent with the way that many industry stakeholders currently resolve their individual issues through private negotiation. Critically, it would also allow stakeholders to resolve issues in a holistic manner that recognizes the inherent interconnectedness of a network industry.

If carriers adopt the recommended collaboration framework, there are three immediate initiatives they can pursue. **Appendix B** contains a timetable to guide carriers in their initial adoption of this framework. Carriers should consider these steps even if they do not adopt the overall recommendation, as each action will strengthen their defense against current shipper claims.

First, carriers should drive the regulatory debate on the basis of empirical analysis. This means making better use of existing data, improving and expanding data collection, and undertaking quantitative modeling to support any negotiations. Second, carriers should utilize this empirical analysis to frame a long-term strategy that focuses on the benefits of a well-capitalized and productive freight rail industry to broader American competitiveness. This strategy should be based on forecasts of key financial and operational variables for carriers and other industry stakeholders. Finally, carriers should prioritize communicating these results with stakeholders to promote the formation of a broad industry consensus.

Though this approach will face considerable internal and external resistance, this report argues that carriers can overcome these barriers through committed leadership and effective communication of the mutual benefits of long-term collaboration.

## Chapter 1 Current Environment

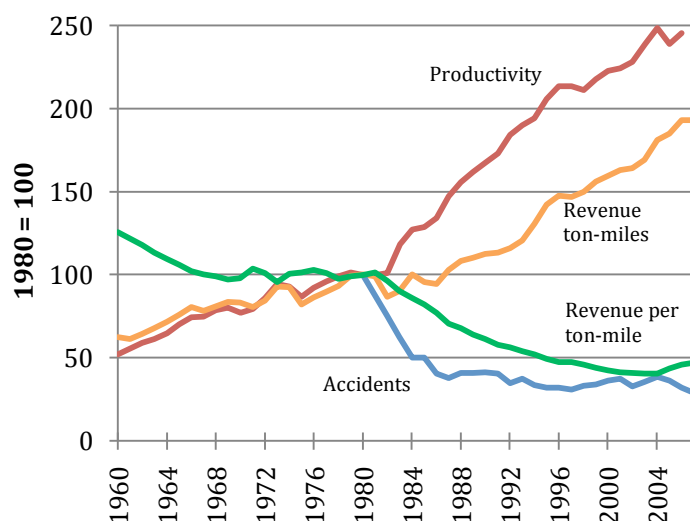
Rail is an essential transport mode for many American industries — including the automobile, coal and grain sectors — and is an efficient, safe, and environmentally-friendly way to move goods around the country. In 2007, freight railroad companies in the United States operated more than 140,000 route miles, employed nearly 190,000 workers, and carried approximately 40% of the nation’s freight.<sup>1</sup> From a historical perspective, the industry is in a healthier state than at any point since World War II and seems well placed to serve the needs of America’s economy in the 21<sup>st</sup> century. Yet industry participants are engaging in a new round of regulatory debate — almost 180 years after the first American railroad company was chartered and 122 years since freight railroads was first regulated. Chapter 1 explores the evolution of the industry’s current challenges, while Chapter 2 takes a longer-run view of the structural and cyclical elements that have produced these modern dynamics.

### 1.1 Recent Industry Performance

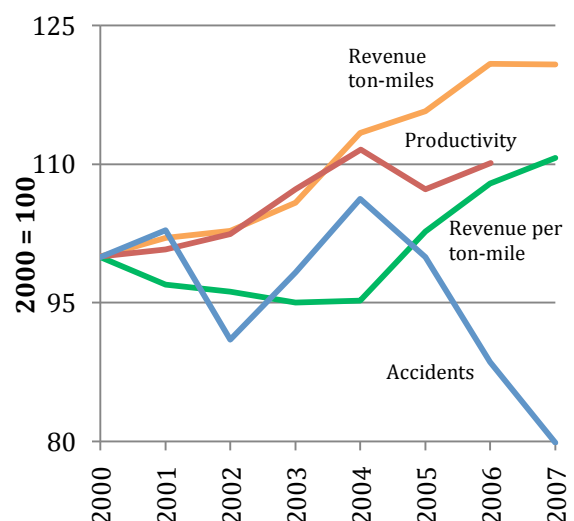
Most contemporary analysis of freight rail performance examines operational trends since 1980 — a year that marked a key inflection point in the industry’s recent evolution as passage of Staggers introduced sweeping deregulatory reforms. This shift was motivated by decades of chronic market failure culminating in a series of high profile bankruptcies in the 1970s. At the time, average rates of return for carriers were around 2%, trains were operated at pedestrian speeds, and the government was openly considering industry nationalization as it did for passenger rail.

Since Staggers, outcomes for all industry participants have improved substantially. For shippers, real rates have decreased by about 50%, while aggregate service time and reliability have improved.<sup>2</sup> At the same time, carriers have become more profitable, with rates of return approaching their cost of capital and enabling greater network investment.

Graph 1a: Industry performance (1960-2007)

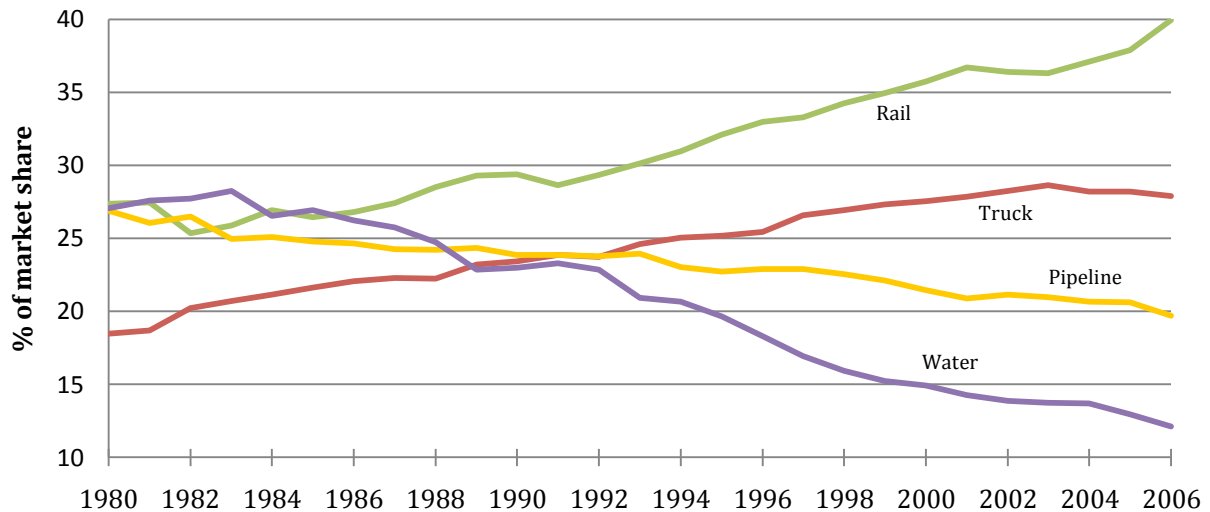


Graph 1b: (2000-2007)



Rail's share of the total freight market has also increased, mostly at the expense of water barges and pipelines, while network safety has improved. Overall, the regulatory changes have produced a "win-win" situation.<sup>3</sup>

**Graph 2: Freight market share (1980-2006)**



This approach to performance analysis — anchoring at 1980 and taking a macro-level view — is useful in explaining how regulatory reform spurred the industry transformation. However, a more nuanced understanding is required to explain why this “win-win” scenario has failed to satisfy all industry stakeholders and prevent the recent push to modify the regulatory regime. Four observations help explain this paradox:

1. Focusing too heavily on contrasting the financial and operational chaos of the 1970s with present industry performance predisposes:
  - a. carriers to overlook recent trends in rates and productivity, which suggest that the mutual gains of partial deregulation may have run their course, fueling shipper *perceptions* of increased anti-competitive behavior; and,
  - b. shippers to overlook the longer arc of historical experience, given that they now benefit from the most equitable and sustainable distribution of industry wealth since the industry’s inception.
2. Rate increases since 2004 may *appear* to be the result of anti-competitive pricing but a confluence of factors including rising input costs, shifting cost structures, and slowing productivity growth complicate any analysis.
3. Aggregating rate trends masks the differential effects of welfare improvements. Gains among shippers have been asymmetrical, as described in the next section.
4. The industry is presently focused on short-term competitiveness *within the industry* rather than long-term competitiveness *of the industry*.<sup>4</sup>

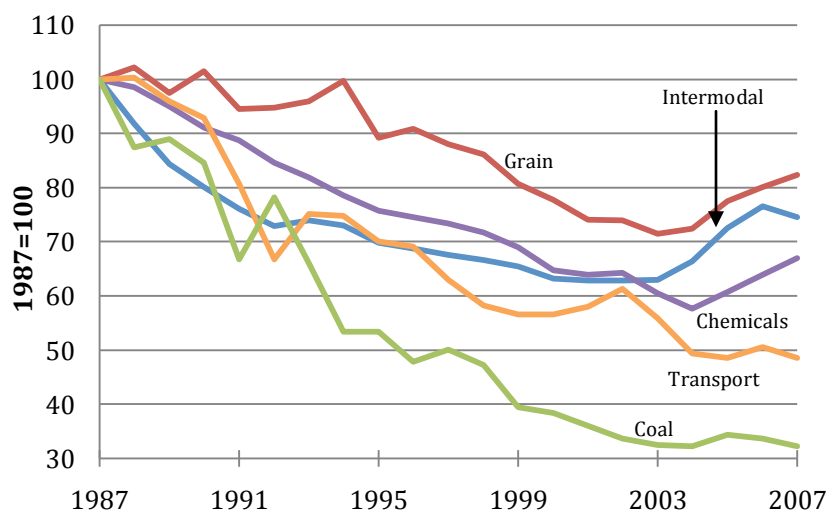
## 1.2 New Regulatory Push

Staggers has not produced a textbook competitive industry. There are still elements of monopoly and oligopoly under the current framework, which is unsurprising given railroad's inherent network economics (see Chapter 2.2).<sup>5</sup> Moreover, the benefits from Staggers have not accrued to all parties equally, as rate improvements have been smaller for so-called "captive" shippers — generally defined as those which:

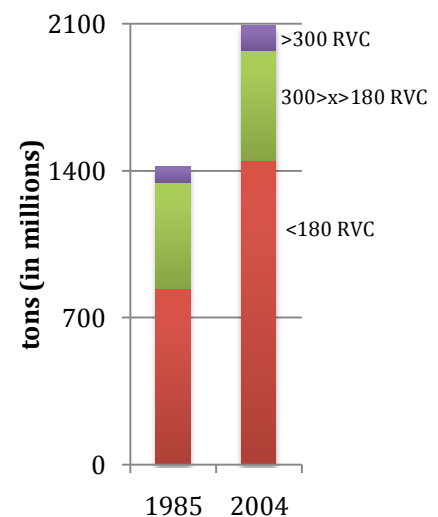
- are serviced by only one railroad, with no alternative railroad within 50 miles;
- are unable to access water- or truck-based transportation;
- cannot:
  - ship or receive a substitute product, or
  - ship products to, or receive products from, an alternative destination that enables the shipper to avoid the single railroad.<sup>6</sup>

In 1999, Grimm and Winston estimated that these shippers, which are primarily in the coal, nonmetallic minerals and chemical industries, comprise approximately 20% of freight rail traffic and pay approximately 21% more than non-captive shippers in freight charges.<sup>7</sup> It is precisely these shippers who are the primary forces promoting regulatory change.

**Graph 3: Revenue per ton-mile by commodity (1987-2007)**



**Graph 4: Increase in traffic >180 RVC**



There are several factors that have recently intensified these shippers' complaints. First, while real rail freight rates are still well below their 1980 levels, they began to increase again in 2004 after more than 20 years of decline, a situation exacerbated by diesel fuel surcharges. While carriers compare today's rates to 1980 rates, shippers note the recent upward trend and worry how it will affect their business in the near- to medium-term, particularly as global economic activity slows.

Second, carrier's economic profits have increased in line with recent rate increases, further substantiating shipper perceptions that carriers are extracting monopoly rents.<sup>8</sup> In the early part of 2009, shippers experiencing decreased downstream demand claimed that

railroad profits were still increasing despite declining shipping volumes — an indication to shippers that carriers may be exploiting their market power.<sup>9</sup>

Third, while rates and carrier profits have been increasing, shippers have complained about declining service quality, reduced accountability, increased cost-shifting, and deteriorating carrier relationships.<sup>10</sup> Shippers also perceive that carriers have intentionally let capacity investment lag to increase their market power.<sup>11</sup> Critically, shippers are able to harness simple individual examples of problems to rally support among receptive legislators.

Fourth, a key industry feature post-Staggers has been consolidation. There were 40 Class I carriers in 1980 compared to only 7 today, the result of both merger activity and changes to the way that carriers are defined. Class I railroads currently account for nearly 70% of track and over 90% of revenue. While mergers have modestly reduced costs and improved service, they may have diminished competition in some markets,<sup>12</sup> with mid-1990s mergers eclipsing typical industry concentration thresholds such as those measured by the Department of Justice's Herfindahl-Hirschman Index. More critical than any actual reduction in competition has been the way that the decrease in Class I railroads has reinforced perceptions of less competition.<sup>13</sup>

Fifth, the existing regulatory mechanisms for protecting shippers have not been working as designed. While some shippers accuse the Surface Transportation Board (**STB**) of bias towards carriers, many complaints relate to procedural injustice — the difficulty of having complaints heard in a timely and cost-effective manner. Filing fees for rate hearings are nearly \$180,000 and hearings can cost \$2-3 million. Recently, the STB has implemented better processes, notably through its simplified standard for rail rate cases, which are of particular benefit in small- and medium-sized rate disputes. Despite recent successes under the new regime, some shippers remain cautious given long-held perceptions that the STB does not adequately address their concerns during regulatory hearings.

Finally, two recent independent reviews have supported some of the shipper proposals:

- In 2006, the Government Accountability Office (**GAO**) found that STB rate relief processes are complex, costly and time-consuming, such that the processes are largely inaccessible and rarely used.<sup>14</sup> GAO also noted that while overall captivity appears to be declining, the percentage of traffic billed at rates substantially above the statutory review threshold has increased (i.e. where revenue is greater than 300% of variable cost).
- In its 2008 report on rail industry competitiveness, Christensen Associates found that recent rate increases were caused by declining productivity growth and increased input costs rather than increased exercise of market power.<sup>15</sup> However, Christensen remained concerned about shipper captivity and railroad performance,<sup>16</sup> and examined numerous proposals for addressing these concerns. Support for reciprocal switching and terminal agreement provisions were the two measures most likely to improve competition with the least economic disruption.



Combined, these factors have placed renewed emphasis on what former Chairman of the Interstate Commerce Commission (ICC) Darius Gaskins has described as the industry’s “residual regulatory issue”.<sup>17</sup> The appropriate remedies for captive or sole-served shippers are a dilemma that “has not been solved to everyone’s satisfaction after 150 years of effort”.<sup>18</sup> Although carriers are broadly satisfied with the status quo, recent trends are strengthening the intensity and credibility of shipper complaints and suggest that regulatory modifications such as those described in the next section will become harder, if not impossible, to avoid.

### 1.3 Congressional Response

Captive shippers have recently been active in pursuing regulatory reform, working through Congressional representatives in an attempt to force a legislative resolution. The latest attempts are largely found in two bills (summarized in [Appendix A](#)) and one act sponsored by representatives sympathetic to shipping concerns:

1. **Competition** – H.R.2125 / S.953: *Railroad Competition and Service Improvement Act of 2007*, sponsored by Rep. James Oberstar (D-MN) and Sen. John Rockefeller (D-WV). This bill has not yet been reintroduced in the 111<sup>th</sup> Congress, but similar bills have been introduced unsuccessfully since the 105<sup>th</sup> Congress. It contains provisions relating to:
  - bottleneck pricing
  - reciprocal switching
  - rate procedures
  - paper barriers
  - inadequate competition areas
  - arbitration
2. **Antitrust** – H.R. 233 / S. 146: *Railroad Antitrust Enforcement Act of 2009*, sponsored by Rep. Tammy Baldwin (D-WI) and Sen. Herbert Kohl (D-WI). This bill contains provisions removing antitrust exemptions that currently apply to the railroad industry and superseding the STB’s authority on antitrust matters. Versions of this bill have been introduced in each of the last two Congresses.
3. **Safety** – H.R. 2095, as amended: *Rail Safety and Improvement Act of 2008*, sponsored by Rep. James Oberstar (D-MN). This bill contains provisions requiring carriers to spend \$1.625 billion on Positive Train Control (PTC) systems from fiscal years 2009 through 2013, and requires the system to be complete by December 31, 2015. It also includes various conditions for labor hours and safety, provides funding and support for the development of high-speed passenger rail corridors to free up congestion, and establishes a federal dispute settlement mechanism between passenger and freight rail.

The safety bill has already passed into law and illustrates the rising interest of legislators in flexing their regulatory muscle, mandating considerable capital outlays for carriers over the next five years beyond their regular network investments. Congress has not yet voted on any version of the other two bills, but as with safety, there are several reasons why competition and antitrust legislation should be the subject of serious consideration in the railroad industry.

First, repeated introductions of the bills indicates there is a defined (albeit potentially small) constituency negatively affected by existing laws — a group that is unlikely to relent. These shippers have strong Congressional influence through the chairmen of the relevant House and Senate committees, whose roles and backgrounds are examined in greater detail in Chapter 2.3.

Second, these two proposals distract legislative attention away from a bill that is in the interests of all industry stakeholders: H.R. 272, the *Freight Rail Infrastructure Capacity Expansion Act of 2009*. Introduced by Reps. Kendrick Meek (D-FL) and Eric Cantor (R-VA), it mirrors similar bills in the 109<sup>th</sup> and 110<sup>th</sup> Congresses. Any taxpayer that constructs new rail infrastructure (whether a carrier or not) would get a 25% tax credit for construction costs, helping to increase capital flows and expand system capacity. While shippers would like this credit to be conditioned on infrastructure that improves competition,<sup>19</sup> the proposed legislation represents an opportunity for carriers to collaborate with shippers to considerable mutual benefit, since funding marginal infrastructure through tax credits will help keep rates that much lower.

Third, even if neither bill passes, there will be opportunity during upcoming consideration of the next Transportation Reauthorization Bill (current authorization expires in September 2009) for Congress to impose additional regulation on the industry, or even “wrap” existing proposals within the broader legislation. It is possible that once these proposals form part of a larger package, they will receive less scrutiny in Congress, improving their chances of being implemented.

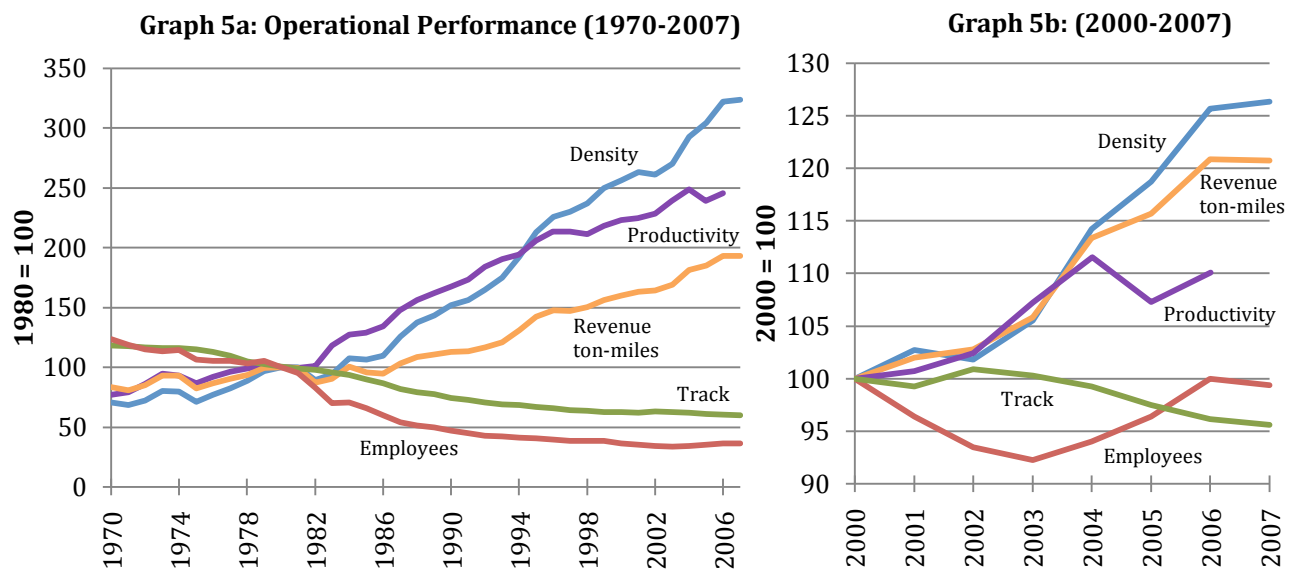
Finally, the 111<sup>th</sup> Congress provides the most fertile legislative environment in a decade for passage of the two bills (or equivalent proposals). Like all domestic industries, freight rail is subject to broader American policy trends. It was one of a number of industries that were partly or completely deregulated in the late 1970s and early 1980s, including airlines, financial services, natural gas, petroleum, and trucking. In the context of the global economic crisis, market failures caused by banking deregulation are in the spotlight. As moves are made to increase financial services regulation, there may be a spill-over into other sectors. If so, regulatory changes proposed but rejected in previous sessions of Congress have an improved chance of success, particularly given carrier’s strong profitability in recent years. It seems that both railroads and shippers perceive that regulatory changes are more likely to occur under the Obama administration than they were under Bush, which has intensified lobbying efforts.

It seems unlikely that many industry participants look forward to another round of regulatory battle in Congress, particularly as it represents a failure by the industry and its regulators to resolve core competition issues and might destabilize the fragile balance that has prevailed since 1980. This impending legislative encounter does, however, provide strong motivation for the STB and carriers to engage shippers in a process that resolves outstanding problems by creating value rather than merely redistributing existing value. Recommendations on how this might be achieved are explored in Chapter 3.

## 1.4 Upcoming Challenges

Whether industry stakeholders can collectively adopt such a process will have a considerable impact on their ability to meet the competitive challenges of the 21st century. In the short- to medium- term, the key question is whether the industry can maintain and improve upon the progress made since Staggers. Having already shed unnecessary labor, abandoned unprofitable lines, consolidated large parts of the industry, made operational improvements and implement new technologies, carriers may have realized most of efficiency gains possible under the industry's current structure.

In recent years, productivity growth among carriers has declined both absolutely and relative to the broader American economy.<sup>20</sup> Most of the future benefit appears to lie in structural adjustments that stimulate carriers to “optimize service times and reliability, to be fully responsive to shippers, and to achieve potential logistical and operational efficiencies”.<sup>21</sup> Realizing this benefit is in the interests of both carriers and shippers.



On a national freight level, the surface transportation program is at a crossroad:

*Will it continue to function as it has since the completion of the Interstate system, pursuing no discernible national interests other than the political imperatives of “donor State” rights and congressional earmarking? Or will it advance concerted actions to confront the transportation challenges facing the Nation that have reached crisis proportions—the deferred maintenance of its basic infrastructure; the burgeoning international trade and its impact on our road and rail networks; the traffic congestion that is crippling metropolitan America; the continued carnage on the Nation’s highways; and powering cars and trucks with fossil fuels, much of which is imported from foreign countries?<sup>22</sup>*

There have been numerous studies in recent years to assess both the wider systemic requirements in the medium- to long-term,<sup>23</sup> and the narrower issue of forecasting rail demand.<sup>24</sup> Consensus has formed about the need for transportation infrastructure investment above current levels to meet expected future demand, driven by population growth, urbanization, expanded trade, and just-in-time delivery.<sup>25</sup> Given little or no change

to current patterns of investment, there is likely to be “significant strains on the capacity of the national freight system over the next 10 to 20 years”.<sup>26</sup> It is not just the amount of investment that is important; it matters into which modes that investment is made, particularly given existing highway congestion and differing carbon emission profiles between modes.

In 2007, Cambridge Systematics estimated rail’s share of the required future investment.<sup>27</sup> Using the Department of Transportation’s 2035 demand projections, Cambridge Systematics argued that carriers would need to invest \$148 billion (in 2007 dollars) for infrastructure expansion by 2035. Class I carriers’ share of this investment was projected at \$135 billion, but the report found that these carriers would only invest \$96 billion based on present revenue and volume growth, and productivity improvements of 0.5% per year. This leaves a shortfall of \$39 billion (\$1.4 billion per year) to be funded from “railroad investment tax incentives, public-private partnerships or other sources”. This conclusion is consistent with Christensen Associates’ analysis that the present *private* economic value of required investments is less than their current price, providing some theoretical support for rate setting above variable costs.<sup>28</sup> The shortfall will be larger if “regulatory changes or unfunded legislative mandates reduce railroad earnings and productivity”.

This analysis is important but deserves scrutiny. Given recent economic developments, it seems likely that the Department’s demand growth estimates should be revised downward. Similarly, while railroad’s carbon emission efficiency relative to other modes is a near term benefit, there may be a longer term downturn in demand for coal, which presently accounts for over 40% of freight by ton and over 20% of revenue. While 30 year forecasts are difficult and Cambridge Systematics’ study is sensitive to numerous economic assumptions,<sup>29</sup> the overall warning is clear. Congestion will continue at localized points in the near-term, with system-wide constraints unlikely to be a major strategic or operational issue.<sup>30</sup> Nevertheless, the prudent course of action for railroads is to maintain flexibility on investment decisions (including capacity ramp-up) by focusing on measures that minimize costs, improve network efficiency and facilitate revenue adequacy.

Carriers should work with captive shippers and their legislative supporters to pursue longer-term improvements to the industry that meet each stakeholder’s unique but broadly complimentary needs. And yet, for the reasons described in this chapter, carriers now find themselves in a struggle simply to maintain the status quo, with short-term legislative battles replacing long-term strategic coordination.

The remainder of this report addresses this disconnect, informed by the unique history and economics of the freight rail industry, and motivations and strategies of its key stakeholders. A thorough understanding of each of these elements and a commitment to strategic longer-term collaboration is necessary to ensuring that carriers can meet America’s future freight demands.

## Chapter 2 Industry Structure

Why study elements of industry structure in assessing strategic responses to regulatory proposals? Understanding the broader historical super-cycles in the relationship between business and government is critical because much of what is occurring today is a reprise of the past – one that delivered mixed results for carriers, shippers, and the industry as a whole. Politics and regulation (and the politics of regulation) form key parts of this checkered past. Economics is also important because there are features unique to freight rail that frame the operating environment between carriers and shippers, and any regulatory proposals or responses must be informed by these realities if they are to achieve the most mutually beneficial outcome. Finally, it necessary to consider the main industry stakeholders, what interests they represent, and how they are shaping the current debate about the industry's future.

### 2.1 Regulatory History

Railroads occupy an almost mythical place in American industrial history, having fueled the growth of capitalism in the 19<sup>th</sup> century, played a critical role in the Civil War, and carried goods and passengers across the country for nearly 180 years. On the one hand, railroad history captures the spirit of American entrepreneurialism, the success of private ventures in driving economic growth and technological progress, and an evolution of business management. On the other hand, carriers were the first mega-corporations to emerge and the industry was the first to draw federal oversight to correct for abuses of concentrated economic power. In 2009, the crux of the regulatory debate is still about the importance of competitive railroads to the American economy and their exercise of monopolistic price-setting. Consequently, there is much to learn from the industry's evolution and the various past attempts to balance private and public interests.

#### 2.1.1 Early history

Formed in 1830, the Baltimore and Ohio Railroad was the first common rail carrier in the United States. Its establishment market the beginning of a boom in speculative investment as railways replaced barges as the primary form of freight and passenger transportation across the growing nation. Unlike its counterparts in continental Europe — where rail infrastructure was centrally planned to facilitate critical troop and supply movements — American railroads were a distinctly private enterprise. Federal and state governments did not have the necessary funds or expertise to undertake construction, not did contemporary citizens favor a powerful public authority.

A critical element of railroad's success was the enormous amount of private investment that carriers attracted to finance their expansion. Railroads required far more capital than barges to purchase and clear land, lay track, acquire locomotives, and coordinate traffic. While \$188 million was invested in canal construction between 1815 and 1860, nearly \$700 million was invested in the construction of railroads between 1850 and 1860 alone.<sup>31</sup> Carriers competed to draw new traffic over existing trunk lines while tapping speculative

fervor in New York, London, Paris, and Frankfurt, fueling their westward growth with the novel promise of “economies of scale”. At the time, government played mostly an administrative and facilitative role, with states providing corporate charters and limited liability, and the federal government issuing 170 million acres of land grants between 1850 and 1872,<sup>32</sup> enabling the construction of transcontinental networks and rapid westward expansion.

After the Civil War, this expansion helped fuel the nascent Industrial Revolution in America. In the absence of regulatory oversight or investment coordination, the subsequent infusion of profit-seeking capital stimulated an overbuilding of the nation’s rail infrastructure to the point of near collapse — much like the telegraph before it and fiber-optic networks a century later. This overcapacity was evident in the five trunk lines that ran from Chicago to New York in 1885, three of which were already near bankruptcy,<sup>33</sup> and a doubling of total track miles between 1870 and 1880 alone.<sup>34</sup> In response, new investment trusts were created by Wall Street’s most influential brokerages to consolidate struggling carriers, better manage competition, and build out proprietary nationwide networks. This massive capital investment precipitated a speculative bubble, but it also laid the foundations for America’s industrial advantage over the first half of the 20<sup>th</sup> century.

By the late 1880s, American railroads had become the worlds’ largest business enterprises, in terms of assets under management, employees and revenues. The effect was to concentrate wealth and, with that wealth, power in small number of individuals, many of whom were linked to railroads — Andrew Carnegie, J.P Morgan, John D. Rockefeller, Leland Stanford, and Cornelius Vanderbilt. Matthew Josephson characterized these men as “robber barons”, rapacious capitalists who made their wealth through unfair business practices.<sup>35</sup> While this depiction has been the subject of considerable historical debate, the robber baron imagery remains powerful and is still used by shippers to describe carriers and frame their regulatory grievances.<sup>36</sup>

### 2.1.2 Regulatory oversight

Contributing to the early negative perception of carriers was the slow development of regulatory oversight. Initial rail regulation came from the states, at the behest of the Grangers — an organization of Western farmers looking to protect themselves against monopolistic rate-setting after years of carrier support during their rapid westward expansion. However, these laws were only partially successful in preventing market abuses such as discrimination and preferential pricing and varied between jurisdictions. After a Supreme Court decision in 1886 that prevented states from regulating any part of interstate traffic,<sup>37</sup> Congress established the first federal regulatory agency in 1887 — the ICC. Its key roles included ensuring that rates were just and reasonable, and railroads did not discriminate, pool freight, or offer special rates to preferential clientele.

While early judicial interpretation of the ICC legislation limited its power, the regulatory train was in motion. The *Hepburn Act of 1906*, *Mann-Elkins Act of 1910* and *Clayton Act of 1914* expanded and refined the ICC’s role to include setting maximum rates and presiding over anti-competitive acquisitions. In particular, passage of the 17<sup>th</sup> Amendment in 1912

— mandating the direct election of Senators — significantly diminished business-friendly legislative oversight. By the time the federal government took control of railroads in 1917 at the end of World War I, overcapacity and rate regulation had already begun to cause significant problems for carriers, with a number already descending into bankruptcy.

Congress passed the *Transportation Act of 1920* to terminate war-time government control of the railroads. It also considerably expanded the ICC's powers, authorizing it to set both minimum and maximum rates and control industry entry, exit, and expansion. In addition, the Act mandated that the ICC prepare an industry consolidation plan and provided for the establishment of a railroad contingency fund that could be loaned to carriers to make investments that were in the public interest. For the first time, railroad legislation attempted to balance dueling considerations — ensuring adequate competition versus maintaining a sufficient return on investment for carriers. It was also early recognition of the need for fewer carriers and identification of investments that may not be economic from a carrier's perspective but may nonetheless have broader public benefits. Though the plan was completed, the proposed mergers were never consummated. After a period of prosperity driven by the "Roaring Twenties", railroads once again suffered badly during the Great Depression. By the late 1930s, nearly 70,000 miles of track (30% of the total) were held in receivership and carrier profits were decreasing sharply.<sup>38</sup>

In 1940, Congress passed another Transportation Act, which continued the theme of balancing fair rates with the economic viability of carriers, and further specified the ICC's merger approval powers. Critically, this Act also gave the ICC a role in overseeing a national transportation policy that required it to preserve the inherent advantages of each mode of transportation. The ICC now had to balance the health of the country's broader transportation infrastructure against the health of rail industry, which continued to decline after World War II. Intense use of equipment and lines during the War put a strain on rail infrastructure, with locomotives, rolling stock, and track in need of replacement and repair.

Yet the prospect of a post-War recapitalization was stymied by increasing intermodal competition, driven by Eisenhower's Interstate Highway System, inland waterway development, and rise of the commercial jet engine. Carriers suffered from diminishing demand, increased competition, a lack of investment capital, a distressed asset base, and network overcapacity. These problems were exacerbated by the ICC, which under its national policy mandate took an even more active role in setting rates and regulating rail operations. Regulatory efforts to increase competition — such as open routing and guaranteed scheduling — pushed vulnerable Class I railroads to the brink of bankruptcy.

### 2.1.3 Stagers and deregulation

By the 1970s, it was apparent that existing regulation was not working, despite the ICC mandate for ensuring industry viability. Rates outstripped inflation, profits plunged and investments were deferred, resulting in increasing accidents and service deterioration. Safety issues caused trains to be operated at reduced speeds, while some track couldn't even support stationary equipment — resulting in "standing derailments". Numerous railroads filed for bankruptcy, including Penn Central (at that time, the largest bankruptcy

in American history). In response to the crisis, policymakers considered nationalization but eventually settled on a plan of decreased regulation — an idea first proposed at a cabinet level by the Weeks committee on transportation policy in 1955.<sup>39</sup> After an attempt at central planning with the *Regional Rail Reorganization Act of 1973*, the Congress passed the *Railroad Revitalization and Regulatory Reform Act of 1976* and Staggers in 1980 as part of a broader suite of deregulatory legislation ushered in by President Carter and expanded by President Reagan.

The capstone Staggers Act was built around restoring the financial health of the railroad industry through the introduction of competition and the prospect of economic gain, while maintaining a venue for rate review where necessary. Its key elements included:

1. rate regulation if a carrier exhibited potential market dominance — as defined by rates that exceeded 180% of the carrier's variable cost of supply;
2. revenue adequacy as an element of rate reasonableness;
3. confidential negotiated contracts;
4. allowance for differential pricing;
5. flexibility to make network investment, divestment, and routing decisions; and
6. permission to change rates quarterly to offset costs.

As outlined in Chapter 1, Staggers' effect on rates, reliability, carrier profits, capital expenditure and safety over the next three decades was substantial. Combined with the deregulation of the trucking industry, Staggers substantially reduced the role of the ICC, which was finally dissolved in 1995. Congress replaced the bloated ICC with a leaner STB, the role of which is discussed at greater length in Chapter 2.4.

On almost any measure, Staggers was a regulatory success. While the post-war regulatory framework is viewed as having choked the industry to a near demise, Staggers is seen as having revitalized the industry and set the stage for its current economic competitiveness. But the relationship between industry health and regulatory oversight isn't binary, as experience from the pre-ICC era confirms. A more comprehensive historical analysis reveals:

- the need to balance any regulatory response to market failures with the financial health of private carriers and shippers;
- the important relationship between political economy and regulatory policy;
- cycles of legislative oversight indicating a constant state of regulatory flux;
- the need for coordination around national transportation policy; and
- the perception of power and legacy in framing current industry relations.



## 2.2 Rail Industry Economics

As the industry has evolved, so too has understanding of its unique economics, which help to explain both the need for government oversight and its impact on public welfare. While there are many dimensions to these conditions, the major issue since the Grangers first pushed for state legislation over 130 years ago has been *differential pricing*; that is, pricing certain freight movements above the marginal cost of providing the service. Differential pricing is both fundamental to the economics of private railroad networks and the major source of conflict between carriers and shippers. As a result, it is critical that carriers communicate their underlying justification for differential pricing, and recognize why it seems like an inequitable system to some shippers.

### 2.2.1 Networks and economies of density

Freight rail is a network industry subject to economies of density. Once substantial initial investments are made, the average cost per network user decreases as the volume of traffic increases. Industries subject to economies of density naturally evolve into monopolies since it is cheaper for one large firm to supply a particular market than for many smaller firms to serve that market. Rates are ultimately lower than they would be under competitive conditions since less capital is required to service the same user base. This contrasts with the typical shipper environment, in which economies of scale are important up to the point at which additional capital and labor are required to expand production. This need for further investment creates an incentive for new market participants, enabling competition to drive prices towards marginal cost.

Since unit costs for natural monopolies continue to decline as volumes increase, firms cannot cover long-run costs through marginal cost pricing alone. To remain financially viable, firms must set prices for at least some customers above their marginal cost — an exercise of market power that is essential to maintaining network integrity. In determining how to price above marginal cost, carriers cannot directly identify what portion of overall costs are associated with specific network movements. As a result, carriers use *demand-based* differential pricing, rather than *cost-based* pricing, meaning that shippers pay a different markup over marginal cost depending on how much they value the network, as determined by their demand “elasticity” (price sensitivity). This elasticity is a function of the freight’s underlying value, its substitutability, and intramodal and intermodal competition. Differential pricing maximizes total freight service purchases, increasing the traffic base over which fixed costs can be spread, minimizing network costs for all shippers (albeit in asymmetrical proportions) and maximizing social welfare.

Those shippers who pay rates significantly above marginal cost and rates paid by their peers are the most vocal opponents of differential pricing. Once pricing is based on demand and not cost, accusations of preferential treatment and cross-subsidization are quick to emerge. However, captive shippers have yet to advance a viable pricing alternative that preserves the network’s long-term capital adequacy. Currently, the STB allows differential pricing and will only review shipper rates in excess of 180% of the estimated variable cost of service. In those cases, it falls to the STB to make the difficult

assessment about whether an *exercise* of market power has become an *abuse* of market power. While many shippers acknowledge the necessity of differential pricing, they complain that the STB does not correctly identify when certain “high” rates are an abuse rather than a response to network demand.<sup>40</sup>

### 2.2.2 Revenue adequacy

When assessing rate reasonableness claims, a key factor the STB considers is revenue adequacy — that is, whether carrier’s return on net investment (**ROI**) exceeds the after-tax cost of capital. Pricing in line with revenue adequacy is critical because the capital-intensive American freight rail industry is financed, built, owned, and operated by private carriers. Trucks, airplanes, and barges utilize assets that are funded and managed by the state, but in freight rail, carriers finance expansions, maintenance and infrastructure replacement. Over the past decade, freight rail capital spending as a percentage of revenue has averaged around 15%, compared to around 5% for other surface freight transportation industries.<sup>41</sup> In general, additions are discrete, large, and occasional — investment is “lumpy” — and once installed, remain in place for decades and are difficult to remove or resell. To make these lumpy investments — which ultimately enable more competitive rates, allow efficient service, and avoid network congestion — carriers must earn enough to cover the cost of construction and maintenance and provide an adequate rate of return to attract speculative investment from other profitable investment opportunities.

As highlighted in Chapter 2.1, the problem prior to Staggers was that the industry’s cost of capital dwarfed its meager returns, causing chronic underinvestment and maintenance deferral, leading in turn to safety issues and poor service. There is now an important debate about whether carriers earn their cost of capital, a debate that turns upon different finance methodologies. Under the STB’s former discounted cash flow method, the industry did not earn its cost of equity over the period 1997 to 2005; however, under the newly-adopted capital asset pricing model, the industry has earned its cost of equity since 2001.<sup>42</sup>

**Table 1: Return on equity vs. cost of equity under different methodologies**

	1997	1998	1999	2000	2001	2002	2003	2004	2005
Return on equity	11.5	7.9	8.7	8.7	8.7	9.3	8.6	9.3	11.5
Equity cost (DCF)	13.8	13.0	12.7	13.6	12.6	12.4	12.7	13.2	15.2
<i>Difference (DCF)</i>	<i>(2.3)</i>	<i>(5.1)</i>	<i>(4.0)</i>	<i>(4.9)</i>	<i>(3.9)</i>	<i>(3.1)</i>	<i>(4.1)</i>	<i>(3.9)</i>	<i>(3.7)</i>
Equity cost (CAPM)	11.9	10.2	10.7	10.7	9.2	8.3	8.0	8.2	8.4
<i>Difference (CAPM)</i>	<i>(0.4)</i>	<i>(2.3)</i>	<i>(2.0)</i>	<i>(2.0)</i>	<i>(0.5)</i>	<i>1.0</i>	<i>0.6</i>	<i>1.1</i>	<i>3.1</i>

Carriers argue that CAPM is inferior to a replacement cost methodology, but the STB has refused to adopt this methodology on the basis that the model proposed by carriers is not practicable.<sup>43</sup> This is an area of legitimate debate between carriers, shippers and the STB, and one that might be sensibly resolved once it is considered in the context of a number of other related issues (as proposed in Chapter 3).

### 2.2.3 Competition

One such issue is the extent to which the STB promotes intramodal competition. Competition is critical to establishing the fairness of demand-based pricing, as it provides an upper limit on what carriers can charge shippers as substitutes become more affordable. There is a sizable body of literature on how competition — particularly intermodal competition — has driven down rail rates since Staggers.<sup>44</sup> However, competition within network industries can be problematic, as lumpy and uncertain investments and large sunk costs combine to prevent entry and competition in certain markets.<sup>45</sup> In response, regulators can potentially increase competition by requiring existing infrastructure owners to provide access to competitors. These access rules can have a major impact on revenue adequacy, based on the extent to which carriers face intramodal competition.

Currently, the STB requires some open access, though not to the degree provided in other private network industries such as telephones. Access proposals such as bottleneck pricing and mandatory reciprocal switching are at the heart of the current regulatory dispute. From an economic perspective, the key consideration is whether these proposals can improve competition in those limited areas where carriers have market dominance without damaging efficiency in the remainder of the network. In other words, it is necessary to analyze whether the benefits of those access proposals for captive shippers outweigh the costs to the entire network of reduced capacity and incentive for carriers to invest in infrastructure.

As long as some shippers feel that rates are a function of monopolistic self-interest rather than a legitimate response to network structure, there will be calls to limit the scope of differential pricing and enhance competitive access. In responding to such calls, carriers should focus on the solvency and efficiency of the network as a whole and the impact on their ability to raise and invest speculative capital. The key is to shift the debate from the impact of proposals on individual carriers or shippers to the effect on the unique, privately-financed network structure of American freight rail, the benefits of which have accrued to most stakeholders over the last 30 years.

Differential pricing is fundamental to support a privately-financed freight rail network but remains a key point of contention within the industry. Effectively communicating the economic justification for such rate setting rests on the following principles:

- each element of the economic framework is related to the other elements;
- shipper objections are rational but neither theoretically substantiated nor in the long-term interests of the industry; and
- policies that benefit part of a network maybe offset by costs to the rest of the network.

## 2.3 Stakeholders

From the analysis of freight rail's history and economics, it should be evident that there are broadly five industry stakeholder groups — carriers, shippers, labor unions, legislators, and the regulator. Interactions between and within these stakeholder groups have framed the regulatory debate. Analyzing each group provides insight into how the current stalemate might be resolved in way that ensures a stable and sustainable future for the freight railroad industry. Moreover, it informs a strategy for developing a non-partisan coalition to pursue broadly beneficial changes to the regulatory landscape.

### 2.3.1 Carriers

Carriers can be broken down into two broad categories: the seven Class I carriers (\$360m or more in 2007 operating revenue), which accounted for roughly 67% of track and 93% of revenue in 2007; and the more than 500 Class II and III carriers (short-line and regional railroads) who make up the rest.<sup>46</sup> Each category has its own representation in Washington: the AAR for Class I carriers and the American Short Line and Regional Railroad Association (**ASLRRRA**) for the others. In many respects, the associations' interests are aligned, though there are some key points of difference. Even though the current regulatory proposals are directed almost solely towards the Class I carriers, there is an important role for smaller carriers in the debate, given their successful adoption of orphaned Class I track, incremental network effects as they feed into Class I trunk lines, and their role as counterparties for issues involving antitrust and route exclusivity.

Within Class I, the most important players are the four key transcontinental carriers: Burlington Northern Sante Fe (**BNSF**) and Union Pacific (**UP**) west of the Mississippi; and CSX and Norfolk Southern (**NS**) to the east. These carriers have divergent interests dictated by their geographic coverage, network configuration, and heterogeneous clientele. BNSF and UP operate over a much larger and diffuse geography, utilizing longer hauls to transport commodities to western ports and take containers of goods from ships in those ports to markets in the east. On the other hand, CSX and NS operate a denser coastal network of shorter hauls east of the Mississippi, with greater intermodal competition from trucking, and coordination issues with passenger service. As a result, regulatory proposals affect the western and eastern carriers differentially, causing an asymmetry of interests and potentially reducing the Class I carrier's collective negotiating position. While an east-west consolidation of the four carriers into two transcontinental giants could align the Class I interests, for the moment there are important differences for the AAR to manage.

In fact, the AAR has to manage a number of tensions within its broad mandate. One of the AAR's roles is to "work with elected officials and leaders in Washington, D.C. on critical rail transportation issues to ensure that the railroads meet America's transportation needs today and in the future".<sup>47</sup> However, it also plays a critical function as aggregator and publisher of industry data, and in that context is arguably more influential than the STB. Moreover, the AAR is involved in industry research and development, championing key initiatives such as positive train control, better hazardous material handling, and communicating rail's environmental benefits. There is a tension between the AAR's

information and initiative-related nature and its political advocacy, which includes proactive measures such as promoting the infrastructure tax incentive and defensive measures such as rallying against the recent antitrust and competition bills. This tension may have manifested itself recently in the redesign of the AAR's website, which removed some of the more confrontational advocacy materials ("The REAL Truth about Railroads, Re-Regulation and Antitrust — What CURE Doesn't want you to know")<sup>48</sup> in favor of more factual position papers on "balanced regulation".<sup>49</sup>

The ASLRRRA supports the AAR on the infrastructure tax credit bill, as well as legislation to extend existing short-line construction tax incentives, while opposing the antitrust legislation. Regional and short-line carriers benefit from the ability of Class I carriers to divest non-core track at discounted valuations subject to long-term supply contracts. While Christensen recorded some concerns that smaller carriers had raised with respect to Class I carriers, a key feature of the relationship between the AAR, ASLRRRA, and represented carriers is the presence of a mechanism for resolving their issues: the Rail Industry Working Group. This group administers the Rail Industry Agreement, which was adopted in 1998 to define terms of trade between different carrier groups and deal with issues such as paper barriers, reciprocal switching and interchange service.<sup>50</sup> A critical premise of the agreement is that private sector solutions are preferred to regulatory action, and serves as an example of the collaborative resolution mechanism proposed in Chapter 3.

### 2.3.2 Shippers

Though the strategic forces affecting America's major freight rail supply are diverse, the forces affecting demand are even more so. Since Staggers, shippers have collectively benefitted from lower rates and better service, but the impact of changes has diverged based on the physical nature of their products, proximity of operations to major trunk lines, existence of non-rail freight options, and the price sensitivity of end-use consumers. Consequently, the degree to which shippers are politically active is a function of their exposure to competitive freight pricing.

For low value-to-weight bulk commodities like coal and cement — where rail is the only viable freight option — calls for further regulation are particularly acute. Many of these shippers are represented by Consumers United for Rail Equity (**CURE**), whose mandate is to support legislation that requires railroads to provide more competitive pricing and reliable service. Unlike the AAR, CURE is solely an advocacy organization, dedicated to avoiding the "horror stories of captive rail"<sup>51</sup> and skilled at emphasizing external effects on political constituents when crafting their advocacy positions. Rather than focusing on how higher rates impact power plant finances, CURE argues that "delays in coal deliveries have caused higher electricity prices on Main Street".<sup>52</sup> This language reflects a key lobbying advantage for shippers: the link that can be drawn to price impacts on voting consumers.

Given that different groups of shippers face dissimilar operational challenges, other advocacy groups have emerged to handle their concerns. Some, such as the Alliance for Rail Competition, support the current regulatory changes, while others have either maintained a neutral position (National Industrial Transportation League - **NITL**) or opposed the

changes (the Waterfront Coalition). Both of these latter groups provide interesting perspectives on the current debate.

- In 2007, the NITL (which has traditionally represented shippers but now has carrier members also) adopted a neutral position due to a comprehensive rail compromise agreement it drafted to “develop solutions that would help move all parties beyond the debates that have been raging for years between shippers and carriers, and begin working collaboratively on longer-term issues that would generate benefits for all concerned”.<sup>53</sup>
- In contrast, the Waterfront Coalition represents intermodal shippers moving international commerce through blue water ports, and believes the current policy debate is driven by a small subset of shippers who claim to speak on behalf of all rail customers. It argues that certain re-regulatory initiatives might actually “kill the arm to save the hand”.

Shippers’ interests are as heterogeneous as the commodities they ship. While CURE has gained considerable traction in Washington pursuing its own particular ends, a broader industry solution must include all customer types to best reflect the needs of the entire rail network. Chapter 3 explores how carriers should first reach out to groups that broadly share their interests, then leverage these relationships to influence those captive shippers who remain hostile to regulatory compromise.

### 2.3.3 Labor unions

One group that has remained under-represented in the debate but which has been directly impacted by regulatory change has been the carrier labor force. As discussed in Chapters 2 and 3, Class I shippers were the largest private sector employers during the second half of the 19<sup>th</sup> century and continued to make up a large proportion of total private employment through the end of the 1970s. More importantly, staff reductions played a major part in the productivity and rate gains in the first two decades after Staggers, falling from a peak of 783,000 in 1979 to a low of 155,000 in 2003 — a reduction of nearly 80%.<sup>54</sup> Over this time, labor unions opposed deregulatory measures since they directly threatened their membership.

Interestingly, that trend has started to reverse as carriers have added 12,000 new jobs over the past four years. Unions and their constituencies will benefit from growth in industry traffic, as rail continues to win a greater share of the freight transportation market and productive technologies begin to demand higher-skilled labor. At the forefront of the debate is the United Transportation Union (UTU), which traditionally opposed carrier interests but recently released a statement imploring carriers, shippers, and regulators:

*“...to resolve, amicably and quickly, a long-simmering and too-often acrimonious quarrel over how railroads are regulated by Congress and the U.S. Surface Transportation Board. This dispute threatens the long-term viability of the railroad industry, its ability to increase capacity and improve customer service, its image as the environmentally superior transportation mode, and its immediate ability to attract and invest federal stimulus funds for further productivity enhancements that will*

*benefit rail customers, the carriers and rail labor....Our joint and long-term interests will be better served if we establish a mutually cooperative approach that balances rail industry growth with an equitable process to settle captive shipper concerns over rail market power and pricing."*

It is critical that the carriers engage these important and highly motivated stakeholders when designing and negotiating any regulatory change. While they have no direct control over the regulatory decisions themselves, labor unions have a voice among sympathetic legislators and are necessarily affected by legislative outcomes. Consequently, they may serve as a vital ally in bringing shippers and legislators to the table to discuss the industry's longer-term strategic direction.

#### 2.3.4 STB

At its creation in 1995, the STB assumed regulatory authority over the industry from the terminated ICC and was given fifteen roles, the first three of which were:

- to allow, to the maximum extent possible, competition and the demand for services to establish reasonable rates for transportation by rail;
- to minimize the need for Federal regulatory control over the rail transportation system and to require fair and expeditious regulatory decisions when regulation is required;
- to promote a safe and efficient rail transportation system by allowing rail carriers to earn adequate revenues, as determined by the Board.<sup>55</sup>

Part of the STB mandate is to balance these potentially conflicting priorities. Shipper complaints allege that the STB places too much emphasis on adequate revenues and not enough importance on facilitating competition to establish rates and undertaking fair and expeditious regulatory decisions. A key claim is that the focus on revenue adequacy is a remnant of a bygone era (the vulnerable 1970s) and that the STB has failed to adapt its approach to reflect the conditions prevailing today, which shippers say requires a greater attention to ensuring competition and a check on rising carrier profits.

As discussed in Chapter 1.2, dissatisfaction with the STB is a key driver behind the current regulatory push. To its credit, the STB has moved to address at least one issue: the efficacy of its rate hearing process. This report, however, will focus on a different element of the STB's core mission: minimizing the need for Federal regulatory control over the rail transportation system. In some ways, this is almost a paradoxical requirement for a regulator — creating the conditions such that the regulator is no longer needed. As it stands, the STB has made itself critical to the functioning of the industry, though it has not created a bureaucracy that is nearly as sprawling as the one established by the ICC in the post-WWII period. Its current challenge is to work out how to facilitate a competitive environment that actually minimizes any regulatory influence.

One promising venue for facilitation already exists in the Railroad-Shipper Transportation Advisory Council (**RSTAC**), which was established at the same time as the STB in 1995. Its

fifteen members include representatives of both large and small carriers and large and small shippers, the Secretary of Transportation and STB board members. As an advisory body on regulatory, policy, and legislative matters to the STB, Department of Transportation, and relevant Congressional transportation committees, RSTAC is in theory an influential body with representatives of all key industry stakeholders. It seems within RSTAC's legislative mandate to convene the relevant parties, provide appropriate resources, and encourage good-faith efforts to solve current industry disputes in a way that does not involve Congress. This option will be discussed further in Chapter 3 as an obvious potential venue for initiating a collaborative strategic dialogue.

### 2.3.5 Government

Given the complex web of geographic and operational constituencies at work in the industry, many government agencies and lawmakers have a stake in how the industry is regulated and operated. Beyond the STB, federal government stakeholders with direct industry oversight include the Department of Transportation, Federal Railroad Administration, and National Transportation Safety Board. Other departments have significant interest in rail regulation on behalf of their constituencies — particularly the Departments of Agriculture and Energy. On any issue, it is easy to see how there could be a misalignment of interest between these bodies, reflecting different legislative mandates and political priorities. Beyond these federal regulatory bodies are the interests of states, which have differing levels of exposure to and interaction with the freight rail industry. For some carriers and shippers, state-level interactions can be far more important than federal relations, which was particularly the case in the historical context.

Most important in the current debate, though, are the influential members of Congress who have taken up the cause of shippers. Two members in particular stand out:

- Representative Jim Oberstar (D-MN), who is Chairman of the House Committee on Transportation and Infrastructure. Oberstar recently testified as follows: “I want a healthy rail system. I want competition — either competition or regulation, but I want a healthy rail system that serves this country, and I also want fairness to this country's consumers. And regrettably at this point, we don't have fairness to consumers”.<sup>56</sup>
- Senator Jay Rockefeller (D-WV), who is Chairman of the Senate Committee on Commerce, Science and Transportation. Rockefeller has said that during his Congressional tenure, “one of my main concerns has been how to deal with rail-to-rail competition. For years, freight shippers have been held captive to one railroad with no choices for the distribution of their goods”.<sup>57</sup>

Much of the Congressional support comes from the representatives of mid-West farming states, where many captive shippers are located. One of the key dynamics of the regulatory debate as it plays out in Congress (and particularly with equal state representation in the Senate) is that the affected shippers are geographically concentrated, while Class I carriers span the nation. While there is support in the relevant committees for regulatory change, this has not in the past translated into Congressional support. A pressing question for the freight rail industry is whether current conditions — including the pro-regulatory



environment that appears to be forming under the Obama administration — can now deliver that marginal support.

Stakeholder reactions to the current debate will play an influential role in determining the future of the freight rail industry. If collaboration holds the key to a stable, sustainable future, the critical point is that no stakeholder group is a monolithic block. There is as much diversity within stakeholder groups as there is between groups. This suggests that there is plenty of scope for cross-stakeholder cooperation in search of a non-legislative solution to current issues. Alternatively, it could suggest a coordination problem that can only be solved by legislative imposition (though this explanation is less likely).

Either way, collaboration may be the only opportunity for carriers to influence the debate. Moreover, there are already some precedents and structures for such collaboration. As the next chapter explores, the potential of this proposal rests upon all stakeholders embracing an evidence-based approach to regulatory issues moving beyond polarized, subjective posturing to develop value-creating strategies for long-run industry competitiveness.

## Chapter 3 Strategic Response

In response to current regulatory proposals, carriers could continue their strategy of responding to individual proposals as they arise, which has been relatively successful to date and requires no strategic change. However, given the industry landscape described in Chapter 1, there is a risk that this defensive posturing will not prevent an expansion of regulatory oversight that could limit carrier profitability and operational flexibility.

Alternatively, carriers could shape a regulatory regime designed to enhance the long-term profitability, stability, and competitiveness of America's freight rail network, while maintaining their freedom to manage the network with minimal government interference. Such an approach would involve collaboration with key industry stakeholders, a focus on expanded data collection and evidence-based analysis, a long-term vision and recognition that carriers and shippers form part of a network critical to supporting the real economy.

This chapter begins by outlining the key arguments in favor of this course of action, then adapts a framework for improving the existing regulatory regime and proposes an action plan for implementation.

### 3.1 Benefits

Private negotiation offers many advantages over the legislative approach to industry regulation. Primary among these is that negotiation is far more likely to produce an organic and mutually beneficial resolution to persistent stakeholder concerns. As the industry's history makes plain, Congress has a poor record of producing durable regulation. Even Staggers has not adequately settled the problem of those shippers who pay rates considerably above variable cost.

Despite some historical antagonism in public regulatory disputes, there are numerous industry precedents for stakeholders favoring private resolution, including:

- agreements between carriers and shippers on competition-enhancing arrangements in order to secure STB approval for mergers during the mid-1990s;<sup>58</sup>
- widespread use of private contracts with carriers post-Staggers by both captive and non-captive shippers to secure cost savings and service improvements;<sup>59</sup>
- small and large carriers utilizing the Railway Industry Agreement and Rail Industry Working Group since 1998 to resolve inter-carrier concerns;
- NITL proposing a comprehensive rail compromise agreement as an alternative to legislative proposals in 2007;
- recent private arbitration between Montana grain farmers and BNSF, the only Class I carrier providing freight service to Montana; and
- voluntary exchange of trackage rights by Canadian National (CN) and NS as part of the MidAmerica Corridor to provide faster routes for merchandise and coal between the Midwest and Southeast.

There appear to be strong motivations for the various stakeholder groups to expand private resolution to address industry-wide concerns. For carriers, the increasing likelihood of detrimental legislation should motivate a stable, private solution to long-standing shipper concerns. For shippers, the failure to secure legislative support for increased competition suggests that they have nothing to lose by exploring a collaborative approach. As discussed in Chapter 2.3.3, labor has indicated a strong preference for such an approach. The STB should support a private methodology to fulfill its mandate of minimizing federal regulatory control over the industry. Congress should also favor any outcome that removes its need to legislate, though it may not be as politically fulfilling for members who have supported existing bills. For all parties, private negotiation should involve lower transaction costs, enable contractual flexibility, and provide greater opportunities for mutual benefit.

### **3.2 Obstacles**

Despite the merits of a collaborative approach, there are some barriers to implementation. The first is determining which industry stakeholder or stakeholders will catalyze such a change. It seems unlikely that the STB would take such a bold first step, while it is beyond the Congressional scope to proactively form consensus around the issue. Activist shippers are working through Congress and have no intrinsic reason to change course at this stage. On the other hand, there are other shippers, such as those represented by the Waterfront Coalition and NITL, who could be quickly co-opted to the cause. Ultimately, the drive must come from large carriers and the AAR, given that these carriers are the only stakeholders with both the capacity and initial motivation to start such a process. Carriers should view this setup as an opportunity to frame a complex process from the outset.

This conclusion in turn raises the question of whether collaborative negotiation is too bold for traditionally conservative carriers to even consider. Chapter 1 contains the riposte to this defensive attitude — that is, that a confluence of external factors and historical precedent suggests that the existing approach is rapidly losing its potency. Moreover, rising rates and a sharp decline in productivity means that carriers must look forward with creative intent to identify the improvements that will enhance industry competitiveness, drive innovation, and share some of the gains with its network clientele.

Finally, there are the related concerns of time and scope. If this Congress is more likely than any other in recent times to enact regulatory change, there may not be time to undertake any industry-wide collaboration. However, sufficient progress may be enough to secure Congressional support to delay or block passage of present proposals, so long as carrier efforts are not cynically perceived as a short-term political tactic. In response to concerns that the required scope of collaboration may be too large, there are short-term incremental actions that stakeholders can profitably undertake in pursuit of long-term strategic objectives.

### 3.3 Framework

For these purposes, an appropriate and well-established framework is the three-dimensional design developed by David Lax and James Sebenius of the Harvard Negotiation Project, the elements of which are as follows:<sup>60</sup>

1. *Tactics*. This is the “traditional” style of negotiation, which focuses on what happens “at the table”. In this limited approach, results are determined by communication, strategy, and the relationship between parties. The present regulatory debate could be thought of as an example of this approach, with carriers and shippers using hyperbole and historical antagonism to influence Congress to legislate in their favor.
2. *Setup*. To deliver the most promising outcomes, it is necessary to ensure that the table is set correctly. For carriers, this means engaging the right stakeholders on issues such as STB reform, investment incentives, reciprocal switching, and arbitration, where trading multiple interests may generate mutual benefit and enhance industry competitiveness relative to other freight modes.
3. *Deal design*. Emphasis is placed on deals that create lasting value for all parties to the negotiation by understanding their underlying interests, trading-off those that are different and collaborating around those that are shared. For the freight rail industry, carriers’ dominant interest is in achieving long-term revenue adequacy while captive shippers are motivated not only by securing short-term rate relief but also service quality and simplified regulatory procedures.

This framework recognizes the inherent interconnectedness of a network industry and shifts the focus from intramodal to intermodal competition.<sup>61</sup> It directs the industry away from its present course, or what William Hogan calls big “R” regulation, which frames every problem in its own terms and designs ad hoc regulatory fixes that accumulate to undermine market incentives and invite further intervention.<sup>62</sup> Instead, it encourages the industry to move towards small “r” regulation, which promotes the best possible mix of policies to support a market-based industry.

This report has already described many existing industry tactics, and will now turn its attention to setup and deal design.

### 3.4 Setup

#### 3.4.1 Interests

An important first step in the process is for carriers to define their primary interests and identify those of the other parties.<sup>63</sup> What is “must have”, versus “important” or simply “desirable”? This introspection will be valuable for carriers regardless of whether they proceed down the path to collaborative negotiation. Is revenue adequacy their only concern? Should carriers be concerned about other factors? Is antitrust a legitimate threat? How important is strategic success in 2035 versus 2015? Similarly, dedicating attention to the interests of a diverse range of shippers and the STB will be beneficial to formulating any regulatory response strategy.

In this context, it is relevant to distinguish between *interests* (about which the parties truly care), *issues* (proposals on the table) and *positions* (parties' stands on these issues). There are many incompatible positions in the current regulatory debate — bottleneck pricing, paper barriers, and antitrust oversight — that hide compatible underlying interests, such as maintaining a competitive rail infrastructure. Carriers can better understand the motivations of shippers and labor by probing public and private sources including academics, regulators, and even shippers and unions themselves.

Also important is the need to avoid the following psychological biases when interacting with other stakeholders:

- *Partisan biases* — overconfidence in your position; false polarization of other parties; interpreting information and fairness in your favor; perceiving your interests as important but other's interests as "their problem". These biases are noticeable in both carrier and shipper positions on regulatory issues both historically and in the present debate.
- *Fixed-pie bias* — the idea that all outcomes are zero-sum. There is a powerful sentiment within the rail industry that shippers are out to take profits from carriers, compared with the possibility that the pie can be grown and all parties can have a bigger slice.
- *Availability and vividness biases* — focusing on things which with you have experience and that are easiest to communicate quickly. These biases are frequently used to support shipper positions in industry debates, despite a lack of robust empirical analysis.

Understanding these biases, as well as effective use of information and impartial outsiders (such as academics and consultants) will significantly influence whatever strategy ultimately carriers adopt as well as its likely success.

### 3.4.2 Parties

Another preliminary step for catalytic carriers would be to identify the right negotiating parties.<sup>64</sup> The heterogeneous stakeholder groups described in Chapter 2.3 are an ideal starting point:

- There are shippers, industry groups, and states that are more prone to participating in a carrier-initiated effort than others. However, creating a broad coalition of early proponents would be crucial to the legitimacy of any collaborative effort. Carriers could identify potential partners through existing cross-industry collaborations, the most prominent of which is RSTAC. Additionally, industry conferences are fertile ground for assessing shared interests and showing a willingness to listen and collaborate around potential industry solutions.
- The STB's early support will be necessary, not least because of potential collusion concerns. Carriers will also need support within Congress to prevent the passage of bills that render any private initiative void. Sources of such support include the representatives promoting the *Freight Rail Infrastructure Capacity Expansion Act of*

2009, as well as more conservative lawmakers wary of excessive oversight and big “R” regulation.

- It will be difficult for carriers to engage captive shippers and their supporters. Other shippers and the STB could be influential in attracting those stakeholders. Carriers must express a genuine recognition of their concerns and exhibit a willingness to deal.
- Another complex element is establishing which stakeholders would negotiate and be bound by any agreement. For example, Class I carriers would need to determine whether they would represent themselves given their diverse interests or if the AAR would negotiate collectively on their behalf. Given industry diversity, broad support would be necessary to convince the STB to formally endorse any agreement under the existing regulatory framework.

### 3.4.3 Alliances

Whatever approach they take, carriers must consider their alliances much more carefully. In an unregulated private industry, value is driven by demand and the firm’s operational capability to respond to that demand. From a rail perspective, this means focusing on revenue adequacy to preserve operational capacity. However, in a partially regulated industry, carriers face a value proposition similar to that of a public utility; one where value is determined by demand, operational capability, and public legitimacy and support. In recent years, carriers have minimized their attention towards this different value proposition, and have not optimized their efforts to secure the political high ground. Carriers have been outflanked by shippers, who have a much higher public profile and prominent Congressional support. Given the push for regulatory change described in Chapter 1, and the drivers behind that push, it is important that carriers improve public support for their private operations. Strategic alliances with amenable shippers such as the Waterfront Coalition and unions such as UTU may go some way towards this end.

Expanded strategic alliances with the government may also help to raise consciousness of the public value that carriers offer. As Cambridge Systematics noted in its 2007 capacity study, tax incentives and PPPs appear necessary for carriers to bridge the gap between required infrastructure funding and Class I carrier projected spending. PPPs can play a key role in aligning carrier and government interests in projects that don’t provide sufficient private economic benefit, but which have significant public benefits. They also offer a template for solving complex operational challenges requiring both private and public input, such as solving terminal congestion in major population centers. The AAR is now playing an active role in promoting the benefits of PPPs such as the Alameda Corridor,<sup>65</sup> and carriers should continue to pursue similarly feasible partnership opportunities.

## **3.5 Deal Design**

The next step is for carriers to contemplate how to shape a deal that creates value, rather than one in which parties try to re-allocate value that already exists.<sup>66</sup> In this context, the first principle is to bring as many issues to the table as are relevant to the stakeholders,

because this provides more currency during the negotiation. These issues arise by probing multiple interests, exploring common ground and shared interests, and identifying different priorities. Simultaneous negotiation of multiple issues allows for a much greater trading of interests than if issues are resolved individually, and minimizes the chance of one partisan issue derailing multilateral negotiations.

These principles can be adapted to the current regulatory dispute. Consider the primary interest of carriers — maintaining greater revenue adequacy over their networks to enable timely maintenance, replacement, expansion, and profitability. In addition, carriers require regulatory certainty to support their investment decisions. Conversely, the main proclaimed interest of captive shippers is to avoid rates that they perceive to be uncompetitive. These shippers also articulate concerns about the STB’s efficacy and service quality. There is no direct conflict between the interest of carriers and captive shippers, given that competitive rates in the long-run may require differential pricing to fund expansion and avoid future congestion, but a discord remains between their positions on the various mechanisms proposed to address shipper complaints.

This analysis suggests that there is potential for collaboration that meets all parties’ interests across a range of key issues. The table below indicates how carriers might frame a set of outstanding industry issues that require resolution, indicating their inclusion in existing legislation, how Christensen assessed each issue (if at all), and the key questions to be addressed.

**Table 2 – Issue Matrix**

Issue	Bills	Christensen	Negotiable	Key questions
<b>Reciprocal Switching</b>	Competition	Moderate support	●	Voluntary versus mandatory; scope of switching obligation; rate setting
<b>Terminal Agreements</b>	None	Moderate support	●	Coordination issues; scope of obligation; rate setting
<b>Bottleneck</b>	Competition	No support	●	Threat to differential pricing and network solvency
<b>Paper Barriers</b>	Competition	Neutral	●	Unwinding previous contracts
<b>Trackage Rights</b>	None	Limited support	●	Voluntary versus mandatory; terms of access
<b>Common Carrier</b>	Competition	n/a	●	Hazardous materials; rate setting
<b>Arbitration</b>	Competition	Limited support	●	Type; cost; procedures; appeals
<b>STB Reform</b>	Competition	Moderate support	○	Rate setting; complaint procedures; coordination; data collection
<b>Capital Cost Formula</b>	None	Neutral	●	Accuracy versus complexity; revenue adequacy implications
<b>Tax Incentives</b>	Tax	Support	○	Congestion; covenants
<b>Antitrust</b>	Antitrust	Neutral	●	Dual regulation; rate oversight

● = opposed interests, ● = tradable interests, ○ = shared interests

As indicated in the table, most of these issues pivot on how rates are set, highlighting the need to treat each issue as part of a larger collaborative framework. Despite this potential,

there have been few, if any, attempts to devise long-term solutions to shipper concerns outside of STB hearings and legislative proposals. The challenge of pursuing this approach is that neither side actually knows the potential economic impact of the various issues in discussion. Shippers promote changes without quantifying the magnitude of any benefits, while carriers oppose changes without quantifying system-wide costs. This lack of empirical evidence would likely be exposed in a negotiation as neither side would be able to offer anything more than anecdote or economic theory in support of their position.

Two current proposals exemplify this need for better data and analysis to inform all stakeholders about potential impacts and possibilities for collaboration.

### 3.5.1 Mandatory reciprocal switching

Currently, the STB may require carriers enter into reciprocal switching agreements where STB finds it is practicable and in the public interest, or where such agreements are necessary to provide competitive rail service. Under the Competition bill, “may” would be replaced by “must”, and the precedent of requiring “anti-competitive conduct” would be removed. Following the GAO’s lead, this change was advanced in Congress on the basis that it is similar to mandatory inter-lining in Canada and could potentially “reduce the number of captive shippers ... and traffic eligible for the rate relief process”.<sup>67</sup> This comparison does not seem adequate to justify regulatory reform, particularly since the Canadian system is functionally different — it was centrally planned for a public duopoly on a largely linear network with only five major urban nodes. On the other hand, the AAR claims that the change “would drive rail rates down to below-market levels” and cause the STB to be flooded with switching requests.<sup>68</sup> Both of these claims seem somewhat unlikely, particularly if a reasonable rate is paid for access and there remains a qualifying price hurdle beyond which mandatory switching would be imposed.

Christensen Associates found that of all current regulatory proposals, mandatory reciprocal switching (together with terminal agreements) had the greatest “likelihood of resolving shipper concerns via competitive response, without leading to material adverse changes to railroad costs and efficiency”.<sup>69</sup> Yet while Christensen used a stylized model to estimate the impact of mandatory switching on efficiency, the finding that switching would generate a “competitive response” appears to a best guess based on economic theory.<sup>70</sup> Moreover, the report contains no analysis of the Canadian experience. Relative to other proposals, Christensen suggests simply that mandatory switching within a limited radius is more likely to generate adequate competition and less systematically harmful. However, Christensen does not conclude that it will offer shippers significant rate relief and includes an important caveat that the legislative proposal does not address implementation details, leaving open the “very real risks of unintended and economically harmful outcomes”.<sup>71</sup>

Mandatory reciprocal switching should probably be considered as part of any negotiated response to competition concerns. However, proponents should offer some estimate of the number of shippers that would no longer be captive, and estimate the benefit of that reduction. Moreover, proponents should provide implementation details, including whether there would be any geographical limit. If carriers were required to mount a



proper defense of their position, they would need to calculate what percentage of track would likely be subject to this provision and what portion of revenues might be exposed, and then apply Christensen's cost effect estimate. As it stands, however, there is very little data in support of either position, and so mandatory switching does not seem amenable to negotiated settlement. On the other hand, carriers have undertaken switching on a voluntary basis or under merger-related agreements, and so carriers and shippers could explore whether increased voluntary switching could become a tradable negotiation issue.

### 3.5.2 Arbitration

Under the competition bill, a shipper can request that the STB submit certain rail rates, service, and other disputes involving agricultural commodities to final offer arbitration. The STB currently has a voluntary arbitration procedure that requires the assent of all disputing parties. Shippers advance arbitration as a way of avoiding the costs and delays of STB hearings, arguing that it instead provides a commercial solution and a way of reducing federal regulation. Meanwhile, the AAR says that "*arbitrators would have to base rate decisions on rates paid by rail customers in the most competitive markets* that, by definition, have the lowest rates. This could wipe out railroads' high-margin traffic, dooming them to a perpetual inability to cover their costs".<sup>72</sup> It is difficult to know upon what the italicized portion of this quote relies. Christensen noted that stakeholders were concerned that the arbitration provision may produce outcomes that are inconsistent with competitive outcomes and industry economics, given its inherent complexity.<sup>73</sup>

It is difficult to evaluate the merits of the arbitration proposal. It seems plausible that some shippers simply figure that they can't do worse under arbitration than at the STB, and that at least arbitration is relatively expeditious and potentially less expensive. Certainly, arbitration is one way of avoiding the costly STB processes and is used by some carriers and captive shippers to settle rates disputes — for example, BNSF and Montana grain farmers have recently settled their rate disputes under a voluntary mediation and arbitration procedure. While neither proponent or opponent has publicly estimated the impact of this proposal in terms of STB case numbers and hearing costs, it is consistent with the principle of minimizing regulatory control of the industry. It should be considered in any negotiated or legislative agreement, if only to motivate discussion for greater use of private agreements to settle rate disputes, which appears to work for many parties even in the absence of sufficient economic data.

### **3.6 Next Steps**

In response to the current push for increased regulation in the freight rail industry, carriers have broadly two choices. One is to continue their strategy of denying that captive shippers have legitimate performance and rate concerns, waiting for and defending against individual proposals, and treating shippers as adversaries. Given the confluence of factors described in Chapter 1, this approach is unlikely to be an effective long-term strategy as legislative conditions no longer favor the status quo. Carriers' other option is to catalyze a progressive strategy of framing an improved regulatory regime through a collaborative, industry-wide negotiation based on empirical evidence and a shared vision of future

prosperity. This would enable carriers to design a more stable regime that improves productivity, innovation, competitiveness, and capital adequacy.

If carriers adopt the recommended collaboration framework, there are three immediate initiatives they can pursue. **Appendix B** contains a timetable to guide carriers in their initial adoption of this framework. Carriers should consider these steps even if they do not adopt the overall recommendation, as each action will strengthen their defense against shipper claims.

### 3.6.1 Data

Critical to any industry collaboration is that stakeholders debate regulatory change on the basis of empirical merit. This means that proponents need to be able model the benefits and costs of their proposals and assess net impact. In part, stakeholders can make better use of existing data, particularly if they can secure renewed academic interest in the industry and better access to the unmasked waybill database maintained by the STB. However, there is also a case for improving the quality of data collected. There have been some recent improvements in this area, for example in collecting better statistics on service performance, but there is room for improvement in quality, quantity, timeliness, and access to industry data. For example, the lack of accurate revenue data or objective measures of captivity make it difficult to estimate captive shipper numbers. If carriers can better use existing data and expand the collection of new data, they will be able to prepare more empirical and persuasive analysis and conduct more productive negotiations.

Even if carriers continue with their defensive strategy, superior use of existing data to model costs and benefits will enable them to better argue against proposed changes. This should be among the first initiatives of carriers in advance of the upcoming *Transportation Reauthorization Act*, due to be considered in September 2009.

### 3.6.2 Long-term vision

Crafting a long-term vision for the industry will be necessary to align stakeholder interests and engage them in a collaborative negotiation. At a fundamental level, this report argues that stakeholders should focus on the competitiveness of the industry, rather than competitiveness within the industry. Such a focus should be informed by a better empirical understanding of present and future industry economics, particularly in relation to rail's role in meeting America's long-term freight demand. Any vision should include forecasts of aggregate rates, capital investment, demographic shifts, employment, environmental policy, freight traffic, government incentives, input costs, intermodal competition and cooperation, network congestion, safety and service, technological adoption, and any other variable that is likely to affect the rail network in the decades ahead.

In proactively developing the industry's long term strategy, carriers must communicate effectively with all stakeholders, forming the broadest consensus possible with respect to these projections and the impact on key stakeholders should they fail to materialize. This approach should be extended to national transport officials and modal competitors who are facing similar challenges to rail. Once a plan is agreed upon, advocates will need to

promote the plan to the public and legislators to acquire legitimacy and support for the plan and prevent future regulatory encroachment.

### **3.6.3 Consensus building**

Similar to the broad collaboration that allowed Staggers to rescue the industry from near collapse, a new compact between shippers, carriers, and the STB is necessary to position the industry for long-term success. Consensus building will involve developing an initial coalition of supportive shippers (i.e. Waterfront Coalition and NITL) and labor (i.e. UTU). This backing could help to draw other stakeholders into the private compact and increase industry-wide gains. Moreover, once these additional parties are involved, the number of issues under consideration will increase, providing more opportunities to create and trade-off value as consensus begins to form around a sustainable future.

As with the other two recommendations, even if carriers pursue their current strategy, they should invest more time and money into strategic alliances with shippers and government, in order to secure broader backing in the Congress.

## **3.7 Conclusion**

As the freight rail industry considers another round of regulatory adjustment, it is important that CSX and its fellow carriers maintain an active role in shaping the ongoing debate. This report suggests that approaching industry stakeholders with a shared and prosperous vision for American freight rail should both prevent harmful proposals from destabilizing a relatively equitable regulatory regime and sustain long-term industry competitiveness. However, such a shift in regulatory advocacy is likely to face considerable internal and external opposition, as some constituents may not directly perceive the benefits of collaboration, or may be harmed by a reshuffling of strategic priorities.

Communicating the relative merits of this approach based on empirical and logical arguments will be critical to address the concerns of skeptics and rally the support of unlikely beneficiaries. Without strong leadership from the Class I carriers, the industry risks a return to the unenlightened regulation that prevailed at various periods throughout its history. Regulation is not likely to disappear, but it can support all stakeholder interests if designed with all those interests in mind.

## Appendix A – Bill Summary

1. **Competition bill** — H.R. 2125 / S. 953: Railroad Competition and Service Improvement Act of 2007, sponsored by Rep. James Oberstar (D-MN) and Sen. John Rockefeller (D-WV). This bill has not yet been reintroduced in the 111<sup>th</sup> Congress. Main provisions are:
  - **Bottlenecks:** upon shipper request, carriers must establish rates and provide service between any two points on the carrier’s system. This provision is designed to address “bottleneck” cases and overturn court decisions and regulatory precedents that:
    - carriers can determine the location of interchanges and form of rates; and
    - rate reasonableness is determined on the whole length of haul, not its individual segments.
  - **Paper barriers:** prevents STB from imposing interchange commitments in approving the transfer of rail line, and allows STB to review previous interchange commitments.
  - **Reciprocal switching:** STB must require carriers enter into reciprocal switching agreements where STB finds it is practicable and in the public interest, or where such agreements are necessary to provide competitive rail service. Previously, STB retained a discretion to prescribe reciprocal switching, and required evidence of anticompetitive conduct by the carrier.
  - **Inadequate competition areas:** STB may declare areas of inadequate rail competition and impose certain conditions in those areas.
  - **Time limits:** requires STB to post complains on its website, annually report to Congress on complaints and provides time limits for STB to act on shipper complaints.
  - **Obligation to serve:** requires carriers providing common carrier access to do so in a reliable and efficient manner.
  - **Office of Rail Customer Advocacy:** establishes an Office of Rail Customer Advocacy to accept shipper complaints and research the cost and efficiency of rail transportation.
  - **Reasonable rate process:** grants shippers access to STB process for determining rail rate reasonableness and requires that STB adopt a new process for determining rail rate reasonableness based on the railroad's actual costs, including a portion of fixed costs and an adequate return on debt and equity. This process shall not be determined on the basis of the hypothetical customer.
  - **Fees:** reduces fees for filing a rate case with STB from around \$180,000 to approximately \$500.
  - **Arbitration:** either a carrier or shipper can request that STB submit certain rail rate, service, and other disputes to final offer arbitration. There is presently no mechanism for arbitration.

- **Dispute investigations:** allows STB to investigate carrier violations on its own initiative and requires it to investigate all carrier complaints received. Currently, STB can only investigate on complaint and has discretion to investigate any complain received.
  - Predecessors of these bills included:
    - S. 2921: Railroad Competition Act of 2006, H.R. 2047: Railroad Competition Improvement and Reauthorization Act of 2005, and S. 919: Railroad Competition Act of 2005 in the 109<sup>th</sup> Congress.
    - H.R. 2924 / S. 919: Railroad Competition Act of 2003 in the 108<sup>th</sup> Congress.
    - S. 2245: Railroad Competition, Arbitration, and Service Act of 2002 and S. 1103: Railroad Competition Act of 2001 in the 107<sup>th</sup> Congress.
    - H.R. 2784 / S.621: Railroad Competition and Service Improvement Act of 1999 in the 106<sup>th</sup> Congress.
2. **Antitrust bill** — H.R. 233 / S. 146: Railroad Antitrust Enforcement Act of 2009, sponsored by Rep. Tammy Baldwin (D-WI) and Sen. Herbert Kohl (D-WI). Main provisions are:
- **Antitrust laws:** applies federal antitrust laws to all common carriers subject to Board jurisdiction, irrespective of whether the carrier filed a rate or is facing a rate challenge.
  - **Antitrust exemptions:** removes antitrust exemptions, and empowers the Federal Trade Commission to enforce antitrust laws, for control transactions and agreements between carriers to pool or divided traffic, services or earnings.
  - **Injunctive relief:** removes the prohibition against a party seeking injunctive relief against a carrier for a violation of the antitrust laws.
  - **Jurisdiction:** the US District Court would no longer be required to cede primary jurisdiction to STB in civil actions against common carriers.
  - **Board requirements:** when reviewing a proposed rate agreement, STB must consider and make findings on its impact on shippers, consumers and effected communities, which records must be included in the administrative record.
  - **Effective date:** parties engaging in conduct now proscribed by the Act but previously exempted by Board approval 180 days from enactment to discontinue that conduct or become subject to antitrust laws.
- Predecessors of these bills included:
    - H.R. 1650 / S. 772: Railroad Antitrust Enforcement Act of 2007 in 110<sup>th</sup> Congress.
    - S. 3612: Railroad Antitrust Enforcement Act of 2006 and H.R. 3138: Railroad Antitrust and Competition Enhancement Act of 2005 in 109<sup>th</sup> Congress.

## Appendix B – Implementation Timetable

		Apr		May		Jun		Jul		Aug		Sep		Oct		Nov		Dec		Jan		Feb		Mar	
Item	Action	H1	H2	H1	H2	H1	H2	H1	H2	H1	H2	H1	H2	H1	H2	H1	H2	H1	H2	H1	H2	H1	H2	H1	H2
<b>Data Collection</b>																									
	Identifying data relevant to regulatory proposals (Table 1)	█	█																						
	Collecting data where available		█	█	█																				
	Identifying missing but important metrics			█	█																				
	Developing proxy methodology				█	█																			
	Applying appropriate modeling					█	█																		
<b>Long-term Vision</b>																									
	Identifying long-term goals			█	█	█	█	█	█																
	Quantifying long-term goals				█	█	█																		
	Sensitivity analysis and long-term demand forecasting					█	█																		
	Comparing investment projections with sensitivity analysis						█	█																	
	Identifying funding gaps							█	█																
	Identifying funding sources (private and public)								█	█															
	Identifying project collaborators								█	█															
	Identifying potential obstacles (internal and external)									█	█														
	Creating a plan to overcome potential obstacles										█	█													
	Communicating plan to legislators and public											█	█												
<b>Consensus building</b>																									
	Reaching out to primary partners (Waterfront Coalition, NITL, UTU)	█	█	█	█																				
	Reaching out to secondary partners (ASLRRRA, STB, legislators)				█	█	█																		
	Reaching out with partners to hostile stakeholders (ARC, CURE)						█	█	█	█	█														
<b>External landmarks</b>																									
	NCIT Conference				█																				
	NARS Conference				█																				
	ASLRRRA Conference		█																						
	Transportation reauthorization bill											█	█	█	█	█	█	█	█	█	█	█	█	█	█
	TRB Conference																					█			
	AEA Conference																					█			
	Railroad Day on Capitol Hill																						█		
	Rail Shipper Day on Capitol Hill																								█
	UTU Conference																								█

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All graphs are sourced from data from the Association of American Railroads, Bureau of Labor Statistics and Department of Transportation.

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