SIGNIFICANT ISSUES FACING THE RAILROAD INDUSTRY

A presentation at the Northwestern University Transportation Center

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Last two and a half years have been a period of prosperity for the railroad industry

- High rates of traffic growth
- Double digit revenue increases
- Class 1s closing in on revenue adequacy
- Short lines showing less growth but in general doing well

But, it’s not all roses. Serious issues face the industry. Some could bring prosperity to a halt if not dealt with properly.

Will discuss some of those issues today.

- They potentially affect Class 1s and short lines alike
 Issues

• These are not the only serious issues facing the industry. I have chosen them because they seem important to me and because they will fill the time available.

• The issues I will discuss are:
  – the re-regulation movement
  – the need for investment in the railroad system
  – the carriage of hazardous materials
Issue 1 - The Re-regulation Movement

- Considerable recent activity on this issue:
  - Bills in both Houses of Congress to impose greater government controls over railroad operations, including some to impose greater antitrust control.
  - Hearings held this year on coal supplies, and on economics, service and capacity in the industry.
Issue 1 - The Re-regulation Movement (cont’d.)

• The activity reflects concentrated campaigns by several shipper groups to reintroduce government control.
  – Utility industry at the forefront
  – Working the STB and the Congress
Issue 1 - The Re-regulation Movement (cont’d.)

• Movement given a boost by rail industry capacity and service problems of the last several years.

  — Rapid growth in traffic has outstripped the industry’s capacity to respond in certain commodity and geographic markets.
Issue 1 - The Re-regulation Movement (cont’d.)

- Primary purpose today is to identify the issue, not to engage in a broad scale defense of deregulation, or to spend a lot of time rebutting the arguments of those who would re-regulate the industry.

- For a discussion of the benefits of deregulation see Bob Gallamore’s presentation to the Sandhouse Gang on June 12, 2006 (available on the Transportation Center website).
Issue 1 - The Re-regulation Movement (cont’d.)

• In brief rebuttal to the calls for re-regulation I will say only that:
  – Over a hundred years of history tells us that government economic regulation of the railroad industry does not work.
  – Those calling for re-regulation simply want their industry or their commodity to have lower rates.
Issue 1 - The Re-regulation Movement (cont’d.)

– The result inevitably would be either higher rates for other shippers or a lower return on investment for the rail industry.

– If the latter, then the gains made by the industry and its shippers since the Staggers Act will be seriously threatened.

– The following chart cribbed from Bob Gallamore’s June presentation shows what would be the inevitable result of re-regulation.
Return on Investment is the Sine-Qua-Non

If ROI > cost of capital:
- Capital spending expands
- Stronger physical plant; more and better equipment.
- Faster, more reliable service
- **Sustainability**

If ROI < cost of capital:
- Lower capital spending
- Weaker physical plant and equipment
- Slower, less reliable service
- **Disinvestment**
Issue 2 - The Need for Investment

• Related to the re-regulation issue—but also an issue of importance by itself
• Our transportation system’s capacity problems are real and well known. They will get worse if they are not addressed.
  — DOT estimates an increase in total freight traffic for all modes from 15 billion tons annually in 1998 to 26 billion tons annually in 2020.
The railroad industry is no exception

- AASHTO concludes that all railroads need to invest $175 billion to $195 billion between now and 2020 to accommodate traffic growth and to maintain their current market share.

- AASHTO also estimates that the industry will be able to generate up to $142 billion on its own, but that the remainder, up to $53 billion, will have to come from elsewhere.
AASHTO identifies tax credits as one possible form of public sector participation.

Two industry-related tax credit programs are now before the Congress.
Issue 2 - The Need for Investment (cont’d.)

• The existing three-year short line railroad tax credit expires at the end of 2007 and the industry has proposed a renewal for another three years.
  – 50% tax credits for track maintenance or improvements
  – Maximum credit available = track miles x $3,500.
Issue 2 - The Need for Investment (cont’d.)

- The Class 1s have additionally proposed a 25% tax credit for projects that expand freight rail capacity.
  - Available to anyone making the investment (e.g., Class Is, short lines, shippers)
  - Also proposed that infrastructure capital expenditures not qualifying for the credit would be expensed.
  - Proposal has been introduced in the Senate (S3742); expected to be taken up in 2007.
Issue 3 – The Carriage of Hazardous Materials

• The carriage of hazardous materials presents inordinately high risks to the industry—particularly TIH substances (toxic inhalation hazards).
  – TIH only about 0.3 percent of all rail carloads
  – Yet the costs and dangers of a TIH incident can be astronomical; Graniteville, SC incident in January 2005 resulted in nine deaths and reportedly cost NS about $41 million and its insurers perhaps ten times that.
Issue 3 – The Carriage of Hazardous Materials (cont’d)

- More such incidents might put insurance for the industry at risk
- Railroad rates reflect only a very small measure of the risk.
- Railroads must carry these materials under the common carrier obligation.
The answer lies in

- **Improved tank car design** – AAR’s Tank Car Committee soon to propose new standards for chlorine and anhydrous ammonia tank cars to reduce risk of rupture by more than 50%

- **Product Substitution** – The making and use of safer chemicals by shippers and receivers

- **Congressional action** - Either to provide liability limits or to eliminate the common carrier obligation to carry hazardous materials.

  ➢ Industry has advanced this notion in Congressional testimony. I expect to see us push this hard in 2007.
Conclusions

• The industry is prospering
• There are clouds on the horizon
• Issues are significant enough to warrant care and considered response on the part of the industry.
• The industry’s legislative proposals make sense and are worthy of support
• Re-regulation makes no sense at all.
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