SIGNIFICANT ISSUES FACING THE RAILROAD INDUSTRY

A presentation at the Northwestern University Transportation Center

Charlie Swinburn
October 3, 2006

Background

- 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.

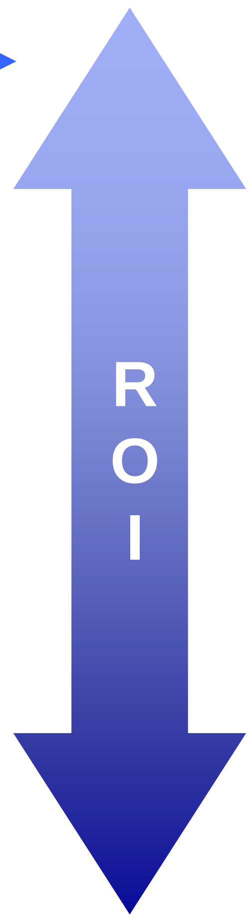
Issue 1 - The Re-regulation Movement (cont'd.)

– 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.

Issue 2 - The Need for Investment (cont'd.)

- 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.

Issue 2 - The Need for Investment (cont'd.)

- 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.
  - There is considerable Congressional interest in a renewal. Action possible post-election in 2006, or in 2007.

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.

Issue 3 – The Carriage of Hazardous Materials (cont'd)

- 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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