Regulation and U.S. Freight Railroads

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Basic Principle Behind Rail Regulation Today

If the U.S. is to have a viable freight rail system:

- Someone has to pay for it.
- The market is far superior to the government in determining who should pay.

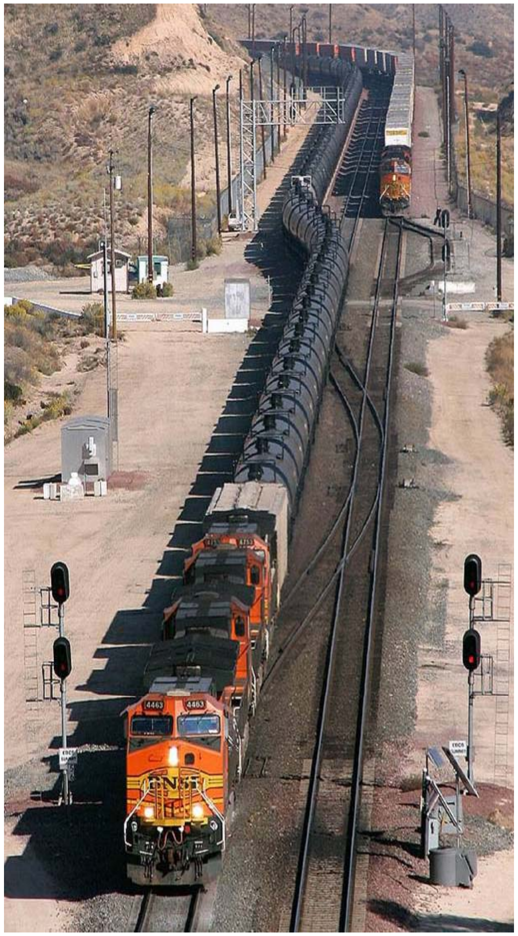
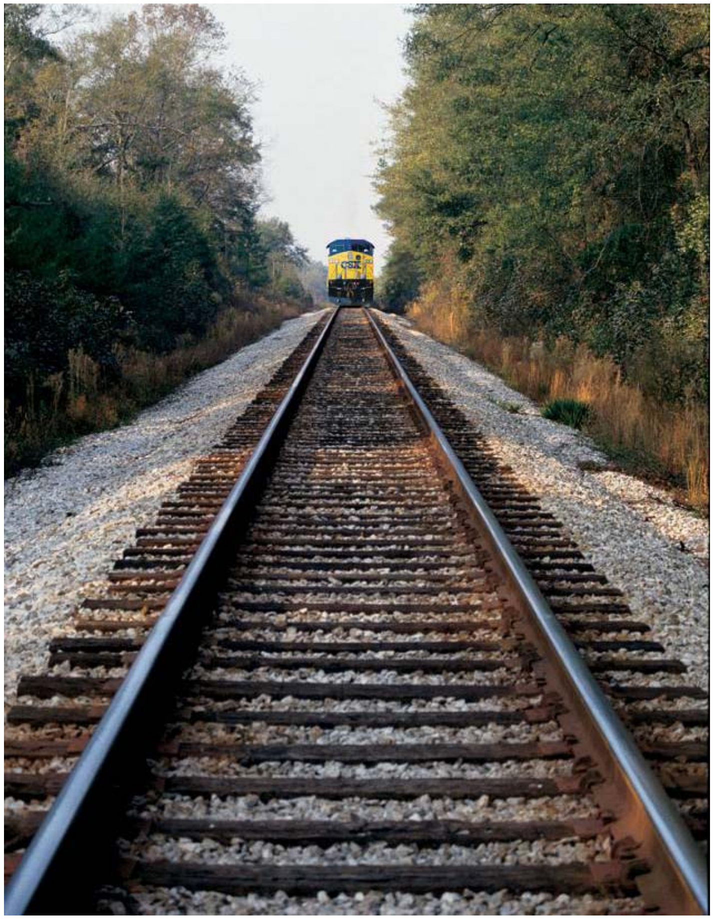


Photo by Dave Toussaint

Singly-Served Is Not the Same as Monopoly Power

- A world in which multiple railroads chase every customer has never existed — and can’t exist.
- Mandated two-railroad service is an attempt to obtain from the government what the market won’t give.



Railroad Profitability

Myth: RRs are "some of the most profitable companies in the world."

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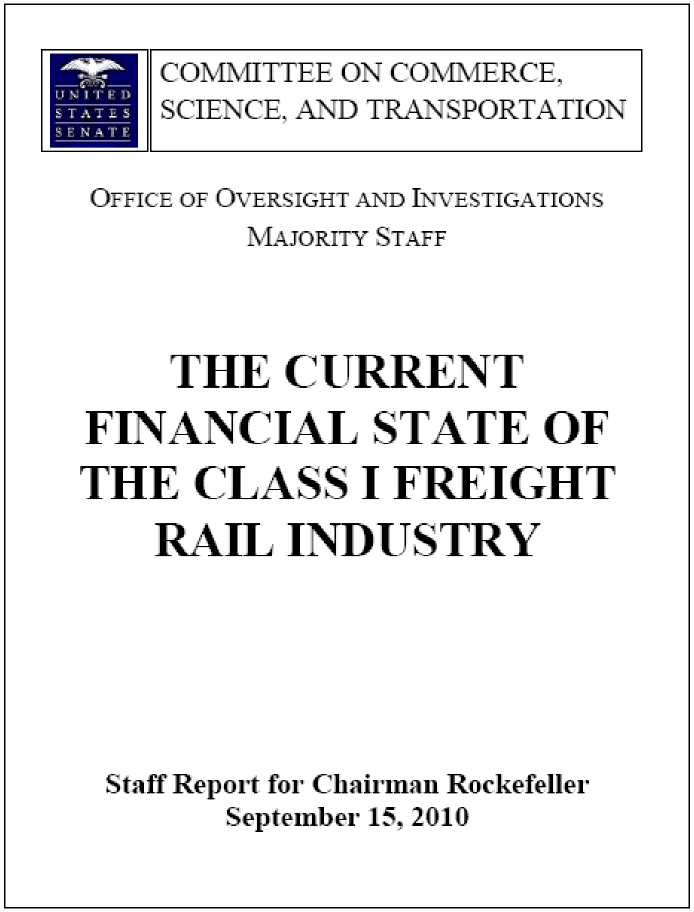
Fact: When properly measured (return to investors), RR profitability is no better than average – even after best RR financial years ever.

Profit margin is not a legitimate way to compare profitability across industries.


UNITED STATES SENATE

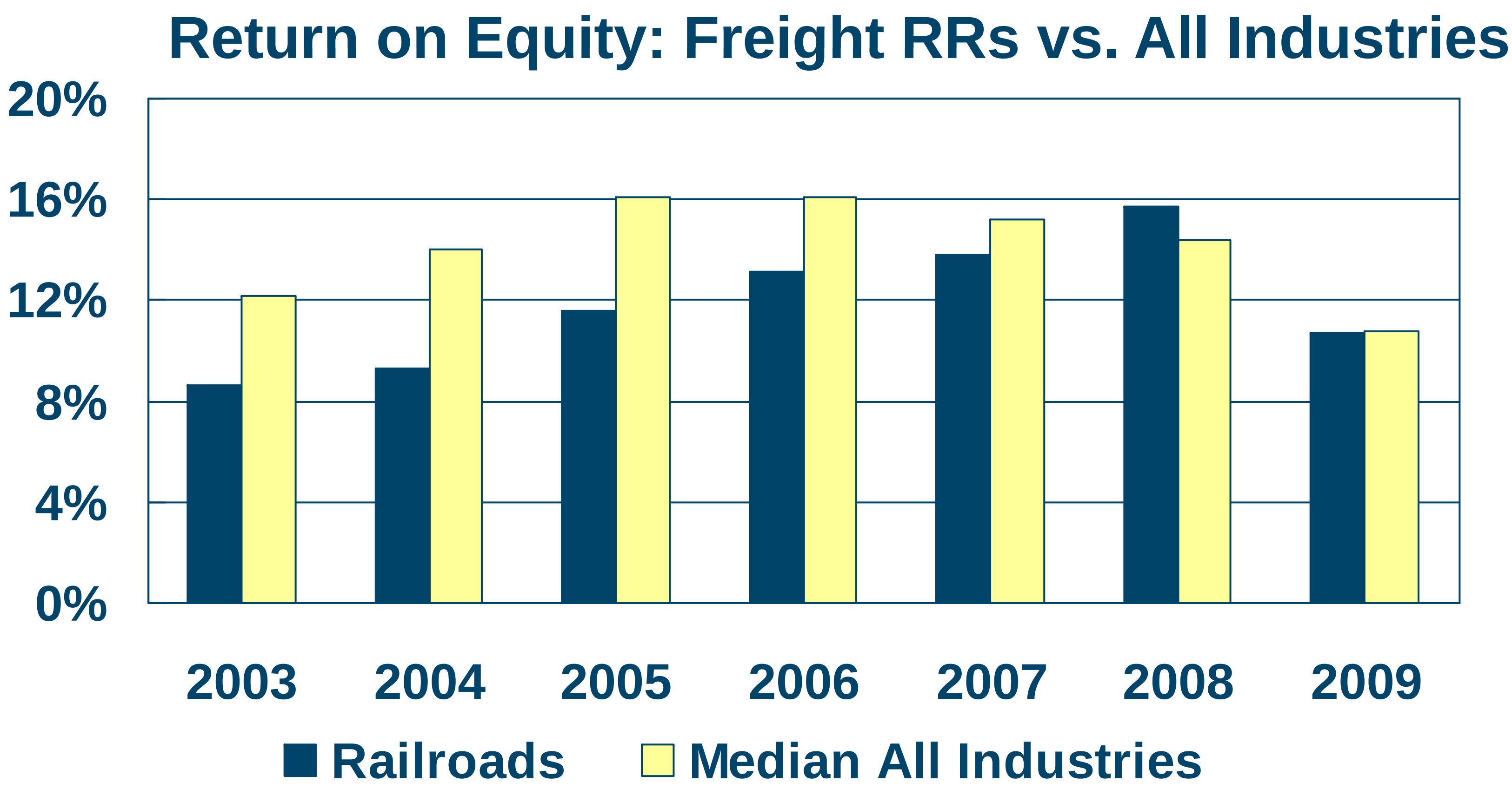
COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION

OFFICE OF OVERSIGHT AND INVESTIGATIONS
MAJORITY STAFF

THE CURRENT FINANCIAL STATE OF THE CLASS I FREIGHT RAIL INDUSTRY

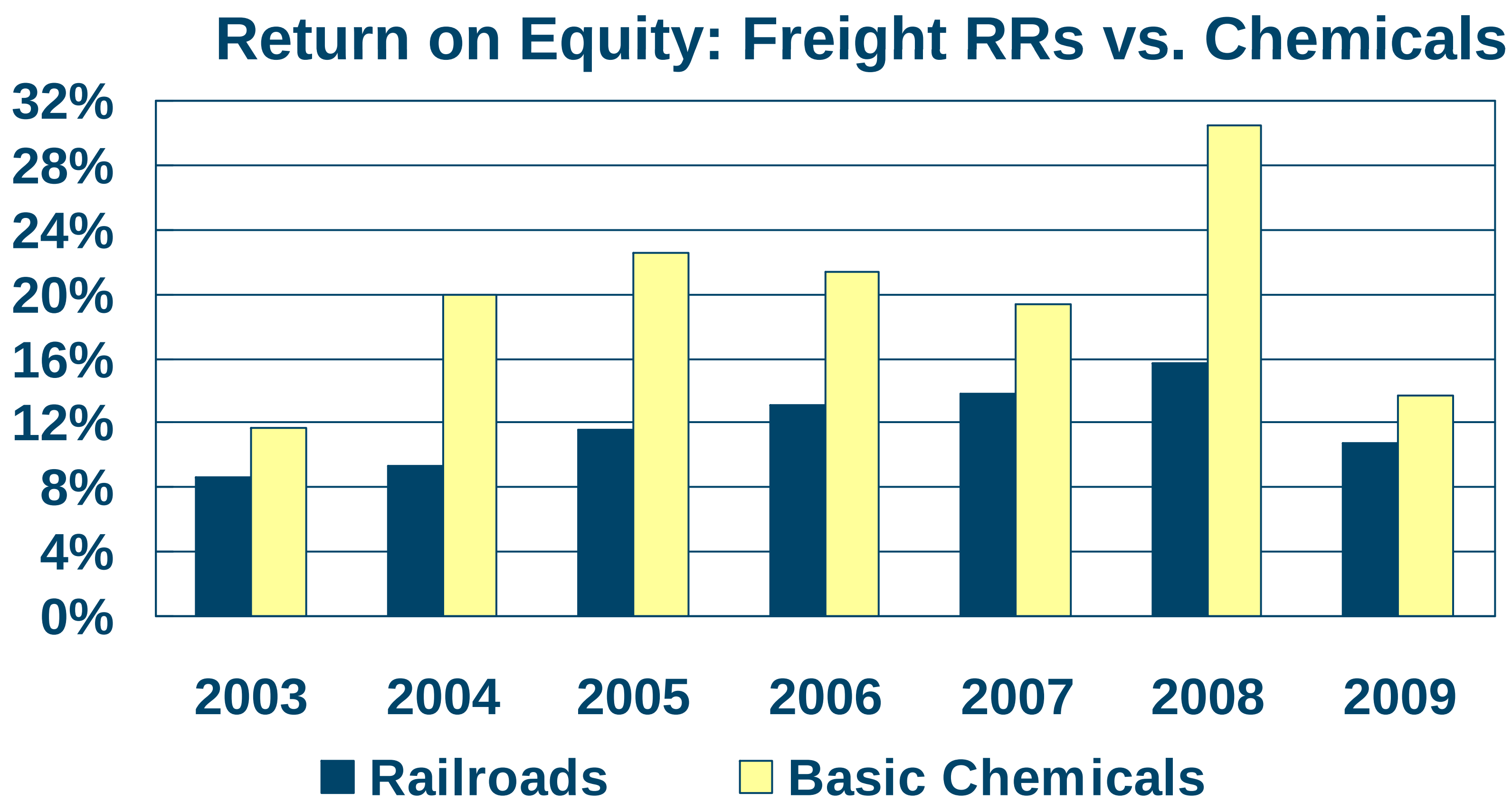
Staff Report for Chairman Rockefeller
September 15, 2010

RRs vs. All Other Industries



Source: Value Line

RRs vs. Chemicals



Source: Value Line

Other Problems With Senate Report

- Operating ratio
- Rate increases
- Dividends and share repurchases
- Public-private partnerships

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RRs Are No Different From Their Customers

- “[P]ricing is...coming from the innovation that we’re bringing to the market place, new products, new applications ...that allow us to differentially extract value from the markets that we’re serving.”
- “They’re all technology driven products that are valued and priced on the basis of the benefits they deliver.”
- “Retail pricing is set based on what the market will bear, not cost.”

RRs Are No Different From Their Customers (cont.)

- "We expect our return on invested capital to be at least our weighted average cost of capital plus 2 percent."
- "Typically we're looking for a return of 3 percent to 5 percent over our cost of capital."
- "We have only one pool of investment dollars and we only fund projects with the highest expected returns, well above our cost of capital."

Railroads and Antitrust

Myth: RRs are broadly exempt from antitrust laws.

Fact: RRs are subject to most antitrust laws.

Exemptions only cover areas subject to STB oversight.

Dual oversight and retroactive application would be serious problems.

Surface Transportation Board

Myth: The STB is a wholly-owned subsidiary of the AAR.

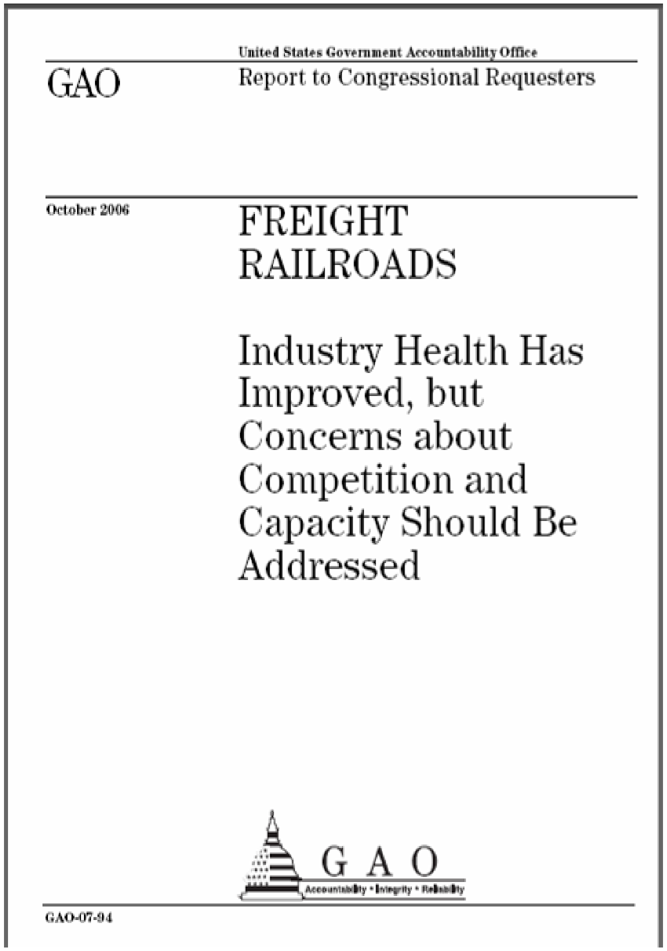
Fact: Since 1996, 8 RR wins, 10 shipper wins, 18 settled.

Other STB actions on paper barriers, small shippers, cost of capital, etc.

2006 GAO Study

"Without a doubt, rates have decreased for most shippers, and most shippers are better off in the post-Staggers environment than they were previously. This outcome suggests that widespread and fundamental changes to the relationship between the railroads and their customers are not needed."

-Government Accountability Office, October 2006



United States Government Accountability Office

GAO

Report to Congressional Requesters

October 2006

FREIGHT RAILROADS

Industry Health Has Improved, but Concerns about Competition and Capacity Should Be Addressed

GAO

Accountability * Integrity * Reliability

GAO-07-94

2008 Christensen Associates Study

- "There is little room to provide significant rate relief to certain groups of shippers without requiring increases in rates for other shippers or threatening railroad financial viability."
- "The overall assessment is that the [rail] industry has not used its pricing power to achieve excess profits."
- "The increase in railroad rates experienced in recent years is the result of declining productivity growth and increased costs rather than the increased exercise of market power."

Association of American Railroads
www.aar.org

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