“Avenues for Encouraging Growth of the Nation’s Rail System”

Karen J. Hedlund
Vice Chair
Surface Transportation Board

As prepared for delivery at the Annual Meeting of the
American Short Line and Regional Railroad Association
Kansas City, Missouri
March 25, 2024

A few preliminary notes. First, nothing I say here today represents the opinion of the STB or any of its other Members. Secondly, as I am sure you understand, I am constrained in what I can say with respect to any matters currently pending before the Board.

The history of American railroads—the greatest in the world—is long and chaotic: The scramble for transcontinental railroads to the west, built well ahead of economic development and population; monopolistic tactics that led to the creation of the Interstate Commerce Commission (ICC); the takeover by the Government during World War I; post-World War II bankruptcies and reorganizations; passage of the Staggers Act, and the more-or-less “final combinations” in the 1990s; ultimately resulting in a collapse in the number of Class I railroads from close to 200 in the early part of the 20th century to only six following the 2023 merger of CP and KCS.

The remaining Class I’s have proved enormously profitable, collectively earning from 2010 through 2023 a staggering $344 billion in net income, of which they returned almost $270 billion to their shareholders in dividends and buybacks. Yet these profits have come at the expense of reliable service to their customers and the economy at large, driven in large part by Wall Street investors seemingly more interested in the next quarter’s operating ratio (OR) than re-investing profits in long-term growth. By our calculations, over the same period they have spent only about $40 billion total on so-called “expansion capital,” or collectively less than $3 billion a year.

So where do we go from here? Can the Class I’s on their own fulfill recent CEO promises to pivot to growth? Do we need changes in our regulatory scheme to address the oligopolistic Class 1 railroad industry, that government—largely through the STB’s predecessor, the ICC—itself allowed to develop? How do we fulfill that part of the Rail Transportation Policy set forth in our statute that requires us “*to ensure the development and continuation of a sound rail transportation system* with effective competition among rail carriers and with other modes, *to meet the needs of the public and the national defense*”?

The Class I's Haven't Grown over the Last 20 Years, and the Outlook Isn't Great

The Board and AAR have both recognized that rail is critically important to the nation's economy, with AAR proclaiming that "America's privately owned freight railroads are the safest and most fuel-efficient way to move goods over land and are the most productive and cost-effective in the world, connecting consumers and businesses across the nation and the world." For many commodities, such as coal and various chemicals, the Board has recognized that trucking is often not a viable option. However, currently, only about 30% of the country's goods move by rail, with rail transportation accounting for only approximately 33% of our exports. But despite the incredible importance of rail transportation to the nation's well-being, it is a well-documented fact that the Class I freight railroads, with over 140,000 miles of track in the United States, have failed to grow their service over the last 20 years.

As many of you know, Loop Capital publishes rail volumes for each of the Class I's in its weekly State of the Rails Report. As seen in this summary chart, coal shipments have declined almost 50% in the last twenty years, although this has been partly offset by a 29% growth in intermodal shipments. Merchandise traffic—everything else (excluding grain)—has shrunk by almost 13%. So, to put a bow on this: over the last two decades, all rail transportation sectors other than intermodal have shown significant negative growth.

Deloitte Consulting has estimated that, in contrast to the recent 30% market share for rail, trucking accounts for approximately 44% of this country's freight transportation market, further observing that the future prognosis is not good: the Bureau of Transportation Statistics forecasts that rail's overall share of freight transportation will continue to shrink relative to trucking through 2050. OliverWyman projects that this ongoing dynamic will likely result in 16,000 extra deaths, necessitate 17,600 added lane miles of roads, and cost $128 billion in lost operating income.

Rail Transportation Is Essential to Combatting Climate Change

AAR further acknowledges that railroads are "[e]ssential to a greener, less congested future, accounting for just 0.5% of total U.S. greenhouse gas emissions and just 1.7% of transportation related greenhouse gas emissions. On average, railroads are three to four times more fuel efficient than trucks. A single freight train can replace several hundred trucks." Indeed, railroads have long bragged about their much smaller carbon footprint than trucking, and growing public concern over the global increase in greenhouse gases has led some railroads to present their projects in terms of how the investments would take trucks off the road. For example, CP asserted that its merger with KCS would shift approximately 64,000 truckloads annually from road to rail in North America. The Board, in the course of its seven-year oversight of the merger, will be carefully tracking these truck-to-rail diversions and monitor how this all plays out.

The lingering question, however, is whether the Class I railroads are properly incentivized to grow their traffic base to help achieve the country's environmental goals and galvanize the continuing evolution of our nation's economy.

Recent Challenges Faced by the Freight Rail Industry

Most recently, the inability of our railroads to respond to the country's economic needs was embodied by the post-COVID rail service meltdown, when the Class I's exhibited a severe lack of resiliency in responding to market needs. As a result, the Board held a hearing in April 2022 to address urgent rail service issues and plans for recovery in EP 770.

Also in 2022, UP issued over 1000 embargoes due to purported congestion on its network, which reflected a sharp increase in congestion-related embargoes and was significantly higher than all other railroads combined. Concerned about the impact that these embargoes were having on UP's customers and the national network, the Board initiated a proceeding in EP 772 and ordered a public hearing that was convened in December 2022 to examine the use of embargoes by UP.

UP certainly was not alone in reducing its workforce over the last decade; the adoption of "Precision Scheduled Railroading" by most of the Class I's reportedly resulted in an overall 30% reduction in the Class I workforce (approximately 45,000 employees).

Recent Signs for Measured Optimism, with a Big Caveat

2023 undoubtedly saw at least something of a rebound in railroad performance. The Board recently reported that the four largest Class I carriers have improved their trip plan compliance for manifest traffic, a meaningful indicator of service reliability, by 17 to 29 percentage points since the first submission of service data in EP 770 in May 2022.

While still down about 14,000 from pre-pandemic levels, railroad employment was up about 3,000 for these carriers in 2023.

A seemingly good indicator, to be sure, but a countervailing trend is unfortunately demonstrated by the recent furloughs announced by all four.

"Pivot to Growth"

Another glimmer of hope: Recently, many of the Class I CEOs have touted an intent to "pivot to growth." For example, at NS's December 2022 investor conference (which preceded the East Palestine derailment), Alan Shaw discussed the concept of managing through a cycle—thinking longer term and taking a more balanced approach to service, productivity, and growth. Shaw artfully defended this strategy at the recent SEARS conference:

> "And why doesn't the rail industry grow relative to truck? Rails have historically underinvested in service. And as a result, whenever there's an economic upturn—

> and there always is—rails never have the number of resources that we need. So, we would offer a lousy service product every two to three years, and we'd miss all kinds of revenue upside which would have provided a lot of value to our bottom line and to our shareholders."

Additionally, while bullish on the prospect of providing better service to shippers, CSX CEO Joe Hinrichs—himself a former plant manager and later President of Ford Motor Company's Global Automotive Business—indicated that rail traffic lost to trucking in the past may be very hard to win back unless the railroads substantially improve their on-time service to customers. Speaking at RailTrends last fall about CSX's year-to-date 88% trip plan compliance figure, Mr. Hinrichs noted: "That's not great. It's good for an industry like ours. It's not great. It's better but it's not great…We have to set ourselves to higher standards. *If we don't do it, the only one left to do it is the regulators."*

Further stressing the importance of better service to current and potential rail customers, BNSF's recent announcement of its new Quantum service with JB Hunt recognizes the need to provide 95% on time delivery of intermodal containers to match the performance of trucks (but at a lower price). (JB Hunt has asserted that Quantum potentially could move between 7 and 11 million truckloads to rail.)

<u>Obstacles to Growth—Activist Shareholders</u>

But here is the key issue: Will investors reward companies that choose to put excess revenue into growth rather than increasing dividends and stock buybacks? Will the Class I CEOs and their Boards of Directors be able to resist inevitable Wall Street pressure to continue to do more with less? The recent attacks on UP and NS management by activist investors are a troubling sign.

STB Chair Marty Oberman recently pointed out that short term investors are focused only on the operating ratio or, as analyst Tony Hatch likes to call it, the cult of the OR. Per Marty:

> "The problem with activist investors bowing down to the cult of the OR is that they are impatient and want immediate returns. Their approach to lowering OR as fast as possible can only be accomplished by drastically cutting payroll and other resources in the short term."

<u>Down the Track—Business Opportunities and New Tools for Growth</u>

In the absence of specifics from the Class I's themselves regarding their long-term plans for growth, what are some potential paths for railroads to gain back customers lost in years past and win new customers away from trucking? Aside from better service performance that could be generated through the reform of certain common operating practices—e.g., letting longer trains go the way of the dodo, and focusing more on reliable departure/arrival times (à la CN's recently-announced "scheduled operating model")—here are a few ideas to kick around.

1. Onshoring and Nearshoring

The pandemic, as well as military conflicts in Ukraine and the Middle East, have recently forced North American manufacturers to face the stark reality of increased geopolitical risks to the global supply chain. As a result, many have turned to "onshoring" or "nearshoring"—i.e., the shifting of new plant investments back to the United States, Mexico, and Canada. This alone led to the reported creation of 261,000 new jobs in the U.S. in 2021 and 350,000 in 2022, a 34% year-over-year increase, while simultaneously helping to shrink the nation's budget and trade deficits.

Not to mention that onshoring can create significant opportunities to compete for new transportation business. Indeed, the historic and growing attractiveness of Mexico for automobile and other manufacturing was one of the stated drivers of the recent acquisition by CP of KCS and its Mexican subsidiary KCSM.

Also, following quickly on the heels of the merger was the announcement by UP, CN, and Grupo Mexico of a new "Premium Falcon Service" to provide a "seamless interchange" service from Canada to Mexico. BNSF's expanded partnership with JB Hunt is also focused primarily on intermodal business and service to Mexico.

2. Collaboration with Short Lines

America's extensive short line network represents one way the long-haul Class I's can reach customers (1) not located on their existing lines or (2) too small or too far away to make investment in a new line extension viable. According to the American Short Line and Regional Railroad Association (ASLRRA), "[t]he nation's 603 short lines provide the first and last mile service for one in five cars moving each year. Operating 47,500 route miles, or 29% of freight rail in the U.S., these small railroads play a vital role in the hub-and-spoke transportation network, providing the connection between farmers, manufacturers, and other industries, and ultimately, the consumer." ASLRRA estimates that 33% of short-line traffic is originated on their lines and transferred to another mode (including Class I's) to reach their final destination, 48% is transferred to their lines from Class I's for final delivery, and 10% is traffic they move from one Class I to another. In short, short lines play a vital role in the overall health of the interstate rail network.

A colleague of mine with years of Class I experience has observed that no U.S. Class I railroad has an opportunistic carload pricing and service model which takes advantage of car supply and available capacity on a real-time basis. And yet independent truckers and large truckload carriers alike routinely use technology which allows them to be productive while simultaneously identifying demand for underutilized assets. Short line and regional railroads do a much better job of scouring the field for these opportunities, and are more agile in real-time communication with their customers. They do this not with high-tech systems, but rather by maintaining close relationships with the customers they have cultivated and, in many cases, brought back to railroad transportation.

Are there other ways that would facilitate the ability of large railroads to better utilize short lines for more First Mile/Last Mile operations? If any conference participants here today have ideas about this, I look forward to hearing them.

3. Investments in Technology

Investments in technology can also lead to reductions in network congestion and capacity increases. The Rail Safety Improvement Act of 2008 mandated the implementation of Positive Train Control (PTC) systems on Class I main lines over which five million or more gross tons of annual traffic and certain hazardous materials are transported, and on any main lines over which intercity or commuter rail passenger transportation is regularly provided. This mandate cost billions of dollars to install, which at the time the railroads vociferously argued was not cost-effective. However, a recent study published by the FRA concludes that PTC and Advanced Breaking Systems not only improve safety but may also enhance overall network performance. Based on a network simulation, FRA estimated that PTC can increase network velocity by 3%, lower capacity utilization by 9.7%, and reduce network delay by 51%.

UP recently announced that after several years of development, it has now implemented a new 21st century transportation management system, called NetControl. Using AI, the new system processes all available information about rail cars movements through UP's network to help manage car inventory, terminal management, shipment tracking, interchanges, and customer communications. Providing real time insights, the system should optimize business performance. The other Class I's are working on similar advances that hopefully will increase usable capacity.

Other new technologies, such as automated devices for moving cars from ports to yards, can also potentially increase capacity. Of course, adoption of these or similar technologies must be balanced against the potential negative impacts on the rail labor force.

Finally, it should be acknowledged that further capacity increases could be generated by additional investment in regular capital maintenance programs to harden assets and thereby allow for higher overall network speeds.

4. Increased State and Federal Investment?

Could more State and Federal investment in our freight railroad system spur growth? Unfortunately, Class I railroads have historically resisted Federal funding. One can speculate that this may be because of the conditions often attached to it, such as environmental compliance, Buy America requirements, "prevailing wage," competitive contracting requirements, and audits and reporting. But there are ways to support freight growth through Federal grants to important railroad partners. For example, the Infrastructure Investment and Jobs Act has supported:

- major expansions to port intermodal rail facilities;
- assistance to short line railroads for 72 projects under the CRISI program;

- funding to eliminate grade crossings, which not only potentially remedies some of the public safety issues associated with blocked crossings but also reduces train delays;

- economic development support for location of new industrial parks adjacent to rail rights of way; and

- improvements to rail yards that will blunt the necessity of building trains on mainlines leading to the yards, thereby mitigating mainline congestion and reducing overall delays.

What the STB Can Do to Encourage Growth and Investment

As a regulatory agency, one role of the STB is to provide a counterbalance to market pressures that currently appear to reward short-term profits at the expense of the public interest. But specifically, when and how should we get involved?

A related query is whether the STB's current regulatory authority is sufficient to adequately protect the public interest and encourage healthy growth of the rail network in the face of the OR cult. While some have raised questions about the limits of the Board's express authority to order railroads to invest more in track and yards, hire more employees, or invest in new customer facilities, it is clear that we do have certain existing powers that can be invoked to discourage railroads from disinvestment.

1. Enforcement of the Common Carrier Obligation

One significant arrow in the STB's quiver is the common carrier obligation, set forth in 49 U.S.C. § 11101(a), which requires railroads to provide transportation or service "on reasonable request." Squishy language to be sure, and the mechanism's focus on the micro rather than the macro is admittedly a bit clunky, but this basic duty represents at least one method by which the Board can prevent railroads from simply reducing operating expenses at the cost of reduced service in an effort to increase profits and pander to Wall Street by artificially shrinking their OR number. The basic promise of the statutory common carrier obligation is that railroads may not refuse to provide service on the basis that doing so would be inconvenient or less profitable.

2. Reciprocal Switching, Terminal Facility Access, and Beyond

A more direct mechanism for fostering competition in the rail industry is reciprocal switching. 49 U.S.C. § 11102(c) statutorily empowers the Board to "require rail carriers to enter into reciprocal switching agreements, where it finds such agreements to be practicable and in the public interest, or where such agreements are necessary to provide competitive rail service." As I'm sure everyone here knows, the Board proposed a new set of reciprocal switching regulations in September 2023 that would, if adopted, provide for the prescription of reciprocal switching agreements to address inadequate rail service, as determined using objective service standards

based on a carrier's original estimated time of arrival, transit time, and first-mile and last-mile service.

While I am currently constrained in what I can say about the proposed rule since it remains pending, I remain hopeful that the Board will act to consider "additional reforms geared toward increasing competitive options—e.g., further changes to the reciprocal switching regulations or other reforms regarding terminal trackage rights, through routes, or the so-called 'bottleneck' doctrine."

3. Future Discussions on Prospects for Growth in Freight Rail Service

We are thus left with the question of what more can be done, and by whom, to incentivize railroads to make significant long-term investments in their infrastructure and workforce to attract a vastly increased number of carloads from producers who today or tomorrow would otherwise opt for trucking as a solution. How do we make rail the mode of choice to drive economic growth? Certainly, further inquiry into this issue is warranted. For this reason, the Board may want to call together a group of industry analysts and economists, labor interests, shippers, Class I railroad executives, and Short Line representatives to discuss additional concrete steps the Board and stakeholders can both take to promote future growth in the rail industry. Again, the economic and environmental health of the country, and the world, depend on it.

Additional Legislative Steps?

The Board's existing powers are all well and good, but the fact remains that the current legal structure of railroad regulation does not expressly prohibit much of what the railroads have done under the general rubric of PSR, including reductions in employment, which has facilitated their return of excess income to shareholders at the expense of investments in further growth.

Revised regulations or new legislation must recognize that the structure of our Class I railroad network has changed dramatically in the years since passage of the Staggers Act, and even ICCTA. Today we have only six large railroads that are generally configured into a set of tripartite duopolies—NS and CSX in the East, UP and BNSF in the West, and two largely North/South Canadian operators in the U.S. with tracks that stretch to the Gulf Coast. Staggers admittedly saved the railroads from an accelerating downward spiral, and did so by intentionally paving the way for mergers that have yielded the six extremely profitable Class I common carriers we have today.

Perhaps it is time for the statutory pendulum to swing the other way. Our predecessor, the ICC, was originally created in 1887 to confront the rise of railroad monopolies. Should Staggers and ICCTA be updated to meet the needs of the current age, and hem in our modern-day "Octopuses?"

Should Congress bolster the Board's authority to regulate more broadly in the public interest, or direct a soup-to-nuts review of existing exemptions? While it seems unlikely that the legislative branch will make significant statutory changes anytime soon, it is my sincere hope

that these thoughts will at least help to further the conversation about what we need to do and how we should go about doing it.

Thank you all for the time you have given me today.