TESTIMONY BEFORE

SUBCOMMITTEE ON SURFACE TRANSPORTATION AND MERCHANT MARINE

OF THE

SENATE COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION

HEARING ON

ECONOMICS, SERVICE, AND CAPACITY IN THE FREIGHT RAILROAD INDUSTRY

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SUBMITTED BY:

JOHN L. McINTOSH

PRESIDENT
CHLOR-ALKALI PRODUCTS
OLIN CORPORATION

ON BEHALF OF
AMERICAN CHEMISTRY COUNCIL

Chairman Lott, Senators, I'm pleased to be here today on behalf of the Olin Corporation and the American Chemistry Council ("ACC"). Olin, headquartered in Clayton, Missouri, is one of the world's best basic materials companies and a leading North American producer of copper alloys, ammunition and chlorine and caustic soda. In 2005, Olin posted sales of approximately $2.4 billion. The company has approximately 5,800 employees working in the United States. Olin consists of three businesses:

> **Olin Brass** - the world's leading developer of high performance copper alloys and the U.S. market share leader in copper and copper alloy strip.
>
> **Winchester** - North America's leading small caliber ammunition producer with powerful global brand name recognition.
>
> **Chlor-Alkali Products** - the largest producer of chlorine and caustic soda in the eastern United States and the fourth largest nationwide.

I am here today on behalf of Olin's Chlor-Alkali Products business, which is the leading producer of chlorine and caustic soda in the eastern U.S. and one of the largest in North America. Besides chlorine and caustic soda, Olin produces Reductone® and Hydrolin® sodium hydrosulfite and hydrochloric acid.

As one of the nation's leading producers of chlorine, the company produces an essential chemical that has played a key role in dramatically reducing infant mortality rates and eliminating water-borne diseases around the world. Our chlorine is also used in the manufacture of swimming pool and spa sanitizers. The biggest end use for chlorine, however, is as an ingredient in polyvinyl chloride (PVC) plastics, including everything from vinyl siding and PVC blood bags to vinyl plumbing pipes.

Another work-horse industrial chemical, our caustic soda is used in household and institutional cleaning products, the pulp and paper industry, and the fabric industry. An agent that aids the dyeing of denim and other fabrics, Olin's Reductone® "helps put the blue in blue jeans." Our Hydrolin® sodium hydrosulfite is principally used in treating kaolin clays, which provide filler material for white paper and other paper products. Our hydrochloric acid is used in the process of making aspartame which sweetens products from diet Coke to snack foods and other consumer products.

Chlor-Alkali Products is headquartered in Cleveland, Tennessee and includes manufacturing sites in New York, Georgia, Tennessee and Alabama. Each of these plants offers a low cost base, highly skilled workers and convenient delivery.

Olin and ACC appreciate the Committee's invitation to participate in this hearing on economics, service, and capacity in the freight railroad industry. ACC represents the companies that make the products that make modern life possible, while working to protect the environment, public health, and the security of our nation. The member companies of ACC depend on the U.S. rail industry for the safe, secure and efficient transportation of approximately 170 million tons of chemical products to customers each year, accounting for more than $5 billion in annual railroad industry revenues.

For a substantial proportion of the shipments from chemical manufacturing facilities operated by ACC members, there is no alternative to using the rail mode. For 63% of those facilities, the

shipper has access to only one rail carrier. Those shipments are subject to what the Staggers Act refers to as "market dominance," which is often described as being "captive" to a single railroad. (Additional monopoly conditions exist when even a non-captive shipper wishes to supply a customer location that is captive to a single railroad.) For a captive shipper, regardless of its size or location, the efficient movement of its traffic – in some cases even the very survival of its businesses – depends on the rates and service provided by that single railroad.

The chemical industry's customers require a constant flow of high-quality products – produced on time – delivered on time – where they want them – at competitive prices. Railroad reliability and service are critical to our economic success. However, that is not what the nation's railroads are providing, especially to captive shippers.

Railroads are experiencing capacity constraints. They're telling us that demand exceeds their ability to provide reliable service in key chemical traffic corridors. We believe them because chemical shippers have seen increases in transit time for our shipments. Slower train speeds and increased dwell times for cars in terminals have led companies to add cars to their fleets at considerable cost to hedge against shipment delays.

It's remarkable that this situation exists in the context of a financially healthy U.S. rail industry. In the 1970s, the rail industry was on its last legs. Regulation had hobbled its ability to respond to competitive forces and cover costs. Railroads lacked the capital to properly maintain their tracks. Eight large railroads went bankrupt during that decade. Many more faced extinction. Policymakers gave serious thought to nationalizing the rail freight system.

But cooler heads prevailed. Instead of nationalization, which would have involved a continuing cost of untold billions, Congress wisely chose deregulation. It passed the Staggers Rail Act of 1980. The legislation, in good measure, led to the success of the U.S. rail industry today.

Yet the competitive landscape in the rail industry has changed dramatically since 1980. As a result, shippers have paid a very high price for U.S. rail industry gains. That's because competition – the hoped-for result sparked by Staggers – has largely fizzled out. Under the Interstate Commerce Commission and later its successor, the Surface Transportation Board ("STB"), the regulatory agency that has authority to address these issues has not done the job.

One reason is that consolidation in the rail industry has reduced the number of Class I railroads (those meeting the STB definition of having operating income exceeding $277.7 million). To be competitive, railroads require competitors. In 1977, there were 63 Class I railroads in America. In 1980, there were about 40. Today, because of massive consolidation, there are just seven Class I railroads serving all of North America. And 90 percent of the nation's rail traffic is handled by only five major railroads.

Although STB has not been presented with another transaction involving two or more Class I carriers since revising its merger guidelines in 2001, railroad mergers inevitably reduce shipper options, regardless of the conditions that are applied by the agency. Bottlenecks are extended when lines serving captive shippers are acquired by connecting carriers. Efficient service from independent "bridge" carriers disappears. Competition for service to new industrial sites is reduced or eliminated. In conjunction with other ICC-STB policies that curtail competition between railroads, mergers have generally harmed captive shippers.

As the inevitable result, whole states, regions, and industries are now captive to a single railroad.

You can imagine the difficulty we face when it comes time to negotiate a rail contract or a rail rate for a captive facility. Lacking the negotiation flexibility and bargaining power that competition provides, freight rates from the monopolistic railroads continue to rise unchecked.

That explains why captive rail rates may reach or exceed twice the amount of a competitive rate. In 2003, Escalation Consultants, Inc., which provides consulting services to the energy and rail shipper industries, studied captive versus non-captive rail rates for several commodity groups. For chemical companies the average non-captive rate for each railroad was about $16 to $20 per ton. In comparison, captive chemical rail shipments averaged $33 to $48 per ton – more than twice as much.

Heightening ACC's concern is that there is no forum other than STB in which to address issues involving railroads and captive shippers. In Staggers, Congress left those issues in the jurisdiction of the regulatory agency and did not de-regulate rail service in non-competitive situations. But STB has not lived up to that responsibility.

Captive shippers are at a disadvantage in a variety of ways. For example, when basic freight rates are established, fuel surcharges are often calculated and applied as a percentage of those rates. As a result, captive shippers pay more in fuel surcharges because there was no competition when the basic freight rates were established. On May 11, STB held a public hearing on railroad fuel surcharges. ACC's analyst found that those surcharges greatly exceed actual fuel costs due to flaws in the methodologies used in calculating the surcharges. Railroad fuel surcharge practices are unreasonable because of five crucial factors:

- <u>Fuel surcharges often are not based on actual fuel consumption</u>: Surcharges should be related to the amount of fuel consumed to provide a specific service to a shipper. Instead, they are based on other, often unrelated factors.
- <u>Fuel surcharges are inappropriately linked to freight rates</u>: Rates are based on a wide range of competitive factors, and their differences are not relevant to the amount of fuel consumed for a particular trip.
- <u>Higher fuel costs are often covered by other means</u>: Railroad fuel costs are captured through several mechanisms, such as the Rail Cost Adjustment Factor. Adding a fuel surcharge often means fuels costs are recovered more than once by the railroad. Such double jeopardy is unfair.
- <u>Some shippers are overcharged because others are not subject to fuel surcharges</u>: Due to certain contracts or other circumstances, some railroads can not impose a surcharge on some customers. But it is unfair and unreasonable to "make up the difference" by unduly raising the charge for customers that do pay surcharges.
- <u>The reasonability of fuel surcharges can only be determined if there is complete data transparency</u>: Railroads should report their actual fuels costs in a consistent, comprehensive and uniform manner so that the STB, shippers and Congress can accurately and readily determine the revenue obtained from surcharges.

The flaws in rail fuel surcharge practices are significant. According to the analysis prepared at the request of ACC by the economic and management consulting firm of Snavely King Majoros O'Connor and Lee, Inc., the manner in which fuel surcharges have been calculated and applied by the railroads to all customer traffic has resulted in an "over recovery in the range of $1 billion for 2005. This is the amount by which Class I fuel surcharge revenues collected by US railroads exceed the increased fuel costs incurred by the railroads."

While we believe the issue of railroad fuel surcharges requires prompt action, STB has set no date for a decision.

The irony is that Staggers was intended to protect captive shippers and promote competition. Congress wisely wanted to avoid the captive shipper conditions that exist today. That Act directed ICC (now STB) to "maintain reasonable rates where there is an absence of effective competition." Again, the STB has not lived up to its responsibility, and its regulatory interpretations have skewed the Act's intent to bring free market forces to bear on shippers and railroads.

Regrettably, the freight rail marketplace of today doesn't behave like a marketplace at all. Instead, it's dominated by five powerful monopolies. It's time to tear down the barriers to competition. Accordingly, ACC supports legislation that would reform railroad regulation: S. 919, the Railroad Competition Act of 2005, is a bipartisan bill whose provisions would promote competition leading to better service at competitive prices.

- S. 919 would eliminate "bottlenecks" that allow monopoly carriers to take advantage of their pricing power to prevent competition over a short, competitive portion of a route.

- S. 919 would overturn STB's anti-competitive "Midtec" decision. Staggers allows captive shippers with facilities located in terminal areas to seek STB's approval for competitive access to another carrier that also serves that same terminal area. But ICC's regulatory action in Midtec has effectively prevented shippers from even requesting, let alone obtaining, such relief.

- S.919 would eliminate so-called "paper barriers" to competition. These are contractual agreements that require a short-line railroad to deliver all or most of its traffic to the major carrier that originally owned the short-line facilities. Such agreements prevent shippers from obtaining competitive service from other Class I carriers that connect to the same short-line.

I urge you to carefully consider these and the other provisions of S. 919.

We also believe Congress should consider putting the rail industry fully under the nation's antitrust laws. The railroads assert that such legislation is unnecessary, given the "extensive economic regulation" of their industry by STB. But the same railroads claim that S. 919 would be "re-regulation." They can't have it both ways.

In our free market economy, monopolies – and the poor service and high prices they foster – belong in the museums of past history. Major rail customers like Olin see no reason why the rail freight industry can't thrive in a competitive American marketplace. The shelter from competition the freight rail industry now enjoys is unfair to rail customers and to consumers who ultimately pay the bills. It's time for Congress to end unfair and uncompetitive market practices. It's time to return to the original intent of the Staggers Act.

A long line of STB policy determinations is harming the competitiveness of the U.S. chemical industry and other key sectors of the American economy. Unless reversed, those policies will ultimately impair the ability of the U.S rail industry to serve all of its customers.

Congress wrote Staggers to clearly and carefully de-regulate those rail rate and service matters that take place in circumstances where shippers really do have competitive transportation alternatives. Because the marketplace works for such rail customers, Congress appropriately removed unnecessary regulatory involvement. ACC believes that Staggers has been successful in that regard.

But Congress also wisely recognized that railroads have what the law calls "market dominance" over certain shippers. In fact, were it not for those situations, there would have been no need for a federal regulatory agency with exclusive jurisdiction over rail industry rates and commercial practices, the construction and abandonment of rail lines, railroad mergers, etc. Staggers was clearly meant to de-regulate only those aspects of shipper-carrier commercial relationships that take place in competitive markets. ICC was retained in 1980 – and STB exists today – to deal with the non-competitive situations.

The anti-competitive policies implemented by ICC and STB are not included in statutory language. Staggers did not mandate such policies, and the agency has acknowledged that it has the statutory authority to reverse its interpretations. But STB almost invariably declines to exercise its discretion in favor of pro-competitive solutions to railroad issues, unless so directed by Congress.

We are at a critical point. Unless Congress acts to reverse STB's policies, they will ultimately weaken the U.S rail industry, to the detriment of rail-dependent domestic industries and the nation as a whole.

As businesses dependent on the railroad industry, we are vitally interested in the financial health of America's railroads. We simply cannot operate successfully in this country without a financially viable railroad industry and a secure railroad infrastructure. Indeed, I believe that the ability of American manufacturers and producers to compete in today's global market is highly dependent on the rail freight industry. Today, unfortunately, the rail freight industry impedes -- rather than enables -- our nation's global competitiveness. American manufacturers and producers find it more and more difficult to remain competitive against manufacturers and producers outside the United States.

After many years of discussion with representatives of the Class I railroads, ACC is convinced that the carriers will not budge from the status quo in which they have complete market dominance over their captive customers – unless Congress acts. We believe the current business model being followed by the railroads will inevitably lead to their financial brink, costing not only railroad shareholders, but also taxpayers and rail-dependent American enterprise. Even the railroads agree that the gap between their annual income needs and their annual income is expanding, not shrinking. This is despite the fact that they have been allowed to consolidate to achieve cost synergies. These synergies should have allowed them to operate more efficiently and in a fashion that permits them to recover their cost of capital. They've also had the opportunity to transfer less profitable track to short line railroads and they have been able to increase the burden on captive rail customers. The result is simply that those customers with no alternative pay the most.

Pursuing a strategy of continually loading more costs on captive rail customers is not a business model that will result in healthy American railroads in the long run. Captive rail customers will try to escape and the universe of captive rail customers is likely to be reduced over time. Some captive customers will construct rail line "build-outs." Some captive customers will shift their manufacturing activities to facilities that have transportation competition. Some captives will

shift their manufacturing to foreign countries, exporting American jobs overseas. Some companies might be forced to close a U.S. plant or to forego an expansion without even having an offshore alternative. Under this business model, the rail industry will be required to load up even more costs on the remaining captives, thus accelerating the cycle.

When considering railroad service, it is important to recognize the "common carrier obligation," under which railroads are required to transport commodities for their customers. The Interstate Commerce Clause of the Constitution grants power to the Congress to write the laws that govern our nation's commerce. Congress recognized the common carrier obligation as the framework on which the entire national railroad transportation system was founded [49 US Code, Subsection 11101(a)]. And it remains crucial today. Railroads are chartered to operate in the public interest because the public depends on safe and reliable service in the delivery of a wide range of products on which we all depend. The common carrier obligation underlines the role of railroads as a service industry that supports so many critical sectors of the U.S. economy.

Let me be very clear: we do not seek a return to the "bad old days" of the 1970's, when several of the major railroads were in bankruptcy and the industry lacked the capital necessary to maintain their systems. Unfortunately, more than a quarter of a century after passage of the Staggers Act, the rail industry apparently continues to fall short of the revenue needed to provide a first class rail system for the nation.

In fact, the railroads are proposing a 25% investment tax credit and first year expensing for infrastructure investments. While some level of investment tax credit for infrastructure may be appropriate, it must be part of a comprehensive solution to rail reliability problems.

There must be a better way for the railroad industry to achieve long-term financial viability while providing efficient, reliable service at prices that will allow American business to compete successfully in the global market. We believe that balanced, fair legislation is needed to bring about a positive relationship between the railroads and the captive customers.

ACC would not ask Congress to resolve issues that could be resolved by railroads and their customers working together to benefit their own industries. But railroad monopoly, supported by STB decisions, is the basic impediment. This dilemma can only be resolved with the intervention of Congress.

Thank you for allowing the American Chemistry Council to present its views, and I would be glad to respond to any questions.