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

Executive Summary

Thirty years ago, Congress made sweeping changes to the laws regulating freight railroads to give the industry the opportunity to improve its finances and its ability to compete against other transportation modes. The Staggers Rail Act of 1980 allowed freight railroads to get rid of unprofitable lines and to consolidate their operations. The law also allowed the railroads to charge lower rates to their customers who operated in a competitive environment, and higher rates to customers who were "captive" to one railroad carrier for transportation service.

A review of the Class I railroads' recent financial results shows that the Staggers Act's goal of restoring financial stability to the U.S. rail system has been achieved. The restructuring of the industry that the Staggers Act set into motion thirty years ago has produced a so-called "rail renaissance." The four Class I railroads that today dominate the U.S. rail shipping market are achieving returns on revenue and operating ratios that rank them among the most profitable businesses in the U.S. economy.

After struggling with declining market share and rates in the years after the Staggers Act became law, the railroads have now regained their pricing power and begun increasing railroads' share of the freight transportation market. Unlike other transportation modes such as trucking, the railroads have been able to maintain their high profit margins even during the sustained economic downturn of 2008-10. Freight railroads have been assuring their investors the companies will take advantage of this "robust pricing environment" and continue to push rate increases on their customers.

While the freight railroads have been investing record amounts of their profits into much-needed capital projects, they have also doubled dividend payments to their shareholders and spent billions more dollars repurchasing their publicly-traded shares to boost the short-term value of their stocks. These large expenditures undermine the railroads' argument that they still lack the income to invest in their long-term capital needs. In addition to their own capital investments, the railroads have recently received hundreds of millions of dollars from state governments and the federal government to support their network improvement activities.

The companies' strong financial performance has attracted billions of new investment dollars, including the unprecedented $34 billion dollar purchase of the BNSF railroad by Berkshire Hathaway, the operating company of the investor Warren Buffett. Buffett predicts that BNSF and the other large Class I railroads will show "steady and certain growth" over the coming decades.

In spite of the obvious financial strength of the Class I railroads, their industry association, the Association of American Railroads (AAR), continues to tell Congress and the Surface Transportation Board (STB) that the freight rail industry is not yet financially stable and is not yet capable of meeting its capital needs without the differential pricing powers the Staggers Act gave the railroads in 1980. As the rail industry continues to operate profitably and to aggressively exercise its pricing power, these claims need to be more carefully scrutinized.

I. Past Financial Problems in the Rail Industry

Faced with a national railroad system in financial decline and physical disrepair, Congress passed the Staggers Rail Act (Staggers Act) in 1980.[1] Citing the railroads' declining share of intercity freight transportation and the industry's poor financial performance, the authors of the Staggers Act said the purpose of the law was to provide "the opportunity for railroads to obtain adequate earnings to restore, maintain, and improve their physical facilities while achieving the financial stability of the national rail system."[2]

The law directed the Interstate Commerce Commission (and its successor, the Surface Transportation Board) to shift its regulatory focus from rate-making to the financial health of the railroad industry. Under this new approach, "the Commission is required to make efforts to ensure that rail carriers earn adequate revenues."[3] The Act legalized private transportation contracts, encouraged railroad mergers, and accelerated abandonment of unprofitable rail lines.

In order to increase the railroads' ability to earn "adequate revenues," the Staggers Act allowed railroads to charge higher rates to shippers over which they had "market dominance."[4] Because railroads could not build their fixed business costs into the rates they charged shippers who had access to competing transportation modes—such as trucks, barges, or other railroads—Congress allowed them to charge higher markups on so-called "captive" shippers without viable transportation alternatives. In order to increase the rail industry's revenues, the Act required regulators to accept as "reasonable" even rates with very high captive-shipper markups.[5] According to the authors of the Staggers Act, regulators would have greater authority to review this so-called "differential pricing" when the railroads were once again financially stable businesses.[6]

The pricing and regulatory reforms in the Staggers Act led to wide-ranging changes in the railroad industry. In 1980, there were 39 Class I railroads, employing 458,000 workers, and

---

[1] Staggers Rail Act of 1980, Pub. L. No. 96-448.

[2] U.S. House of Representatives, *Staggers Rail Act of 1980 Conference Report*, 96th Cong. (H.R. Rep. No. 96-1430) at 80.

[3] *Id.* at 89.

[4] *Id.* at 90-91; 49 U.S.C. § 10707.

[5] A captive shipper is not entitled to STB review of the reasonableness of a rate unless it can demonstrate that the rate produces revenues above 180% of the railroad's "variable costs" in providing the service, and that is has no other transportation alternatives. 49 U.S.C. § 10707. In the railroad industry, "variable costs" are the expenses a railroad carrier incurs in the course of a particular shipment of goods, while "fixed costs" (also known as "joint and common costs") are the expenses railroads incur to maintain their networks, but are not attributable to specific customers or shipments.

[6] *Staggers Rail Act of 1980 Conference Report*, *supra* note 2, at 91. ("The Conferees have adopted the concept of a jurisdictional level that varies according to the performance of the railroad industry. When the industry is earning revenues which are adequate, it is appropriate for the Commission to have the authority to review rate increases more carefully.").

owning 270,623 miles of track.[7] Thanks to a wave of mergers and consolidation in the 1980s and 1990s, today there are only seven Class I railroads. In 2008, these companies employed 164,000 workers and owned 160,734 miles of track.[8] In spite of the fact that the Class I railroads own significantly less track and employ fewer workers than they did in 1980, their network handled almost twice as much cargo in 2008 (1.7 trillion revenue ton-miles) than it did in 1980 (918 billion revenue ton-miles).[9]

Also unlike 1980, today four Class I railroads dominate the long-haul freight market and function as "regional duopolies" in the eastern and western United States.[10] Burlington Northern Santa Fe (BNSF) and Union Pacific dominate freight rail transportation west of the Mississippi, and CSX and Norfolk Southern dominate the business east of the Mississippi. In 2008, these four railroads accounted for over 90% of Class I freight shipments and over 92% of Class I railroads' $61 billion in revenues.[11]

II. Current Financial Picture

In their official communications with the Surface Transportation Board (STB), freight railroad carriers consistently tell their regulators that while their industry's financial condition has significantly improved since 1980, they have not yet reached the "financial stability" goal established in the Staggers Act. In 2007, for example, the Association of American Railroads (AAR), the rail industry's trade group, told the STB that since the passage of the Staggers Act, Class I railroads have "only slowly made progress toward the goal of long-term financial sustainability."[12] While "freight railroads are finally showing tangible signs that financial sustainability might be within reach," the AAR concluded, the companies have not yet reached that point.[13]

A year later, in April 2008, AAR told the STB in written testimony that the railroads' profitability was "still far from stellar in comparison to the many other industries against which

---

[7] Association of American Railroads, *Railroad Facts, 2009 Edition* (2009).

[8] *Id.*

[9] *Id.* Railroads measure the total amount of freight they ship using the measure "revenue ton miles," which is the weight of paid tonnage multiplied by the total number of miles the freight has been transported.

[10] Wolfe Research, *A Training Manual. Will Rail Renaissance Survive Recession and Re-Regulation?* (May 2009), at 10. (hereinafter "Wolfe, Training Manual")

[11] Association of American Railroads, *Railroad Ten-Year Trends, 1999-2008* (Feb. 2010).

[12] Comments of the Association of American Railroads, *STB Ex Parte No. 671, Rail Capacity and Infrastructure Requirements* (April 4, 2007). The STB filings that are cited in this report can be obtained by searching the STB's online database by docket number at http://www.stb.dot.gov/home.nsf/EnhancedSearch?OpenForm&Type=F.

[13] *Id.*

railroads compete for capital" and that "rail industry profitability has consistently lagged most other industries – and that is still the case today."[14]

While the rail industry's regulatory filings with the STB portray an industry that is still struggling to attract capital and to compete with the other transportation modes, the railroads' public financial results tell a different story. According to the four largest rail companies' Securities and Exchange Commission (SEC) filings, in recent years, these companies have far exceeded the Staggers Act's goal of bringing the railroads back from the brink of ruin to financial sustainability. In fact, today, the large U.S. rail companies are some of the most profitable publicly-traded companies in the world.

Policy makers, outside analysts, and the railroads themselves agree that today's industry bears little resemblance to the financially failing, inefficient rail industry of 1980. In 2007, the U.S. Department of Transportation told the STB that the Staggers Act has been "profoundly successful," noting that the railroads are financially healthy, the industry's infrastructure has been modernized, productivity is high, and shippers have benefitted from lower average rates.[15] According to BNSF's CEO, Matthew Rose, after Staggers passed in 1980, the railroads spent two decades going on a "productivity binge, wringing out excess costs, getting rid of inefficient lines, finding wage rates that we all could live within, both for employees and our companies." He told *USA Today*, "we think we are a very productive institution at this time."[16]

As a result of these changes, as well as increases in highway congestion and fuel costs, the railroad industry is no longer at a competitive disadvantage to other transportation modes, as it was when the Staggers Act was passed in 1980. According to a financial analyst at BB&T Capital Markets, four years ago, trucks handled 80% of the freight hauls between 700 and 1,000 miles, while today trucks and railroads split this market.[17] A well-respected transportation analyst, Wolfe Research, predicts that railroads will "likely continue to take market share from the less fuel-efficient and increasingly less productive truck industry."[18]

A review of the largest four railroads' Securities and Exchange Commission (SEC) filings shows just how profitable the large rail companies have become over the last decade. Figure I demonstrates that the four largest U.S. rail carriers have nearly doubled their collective profit margin in the last ten years to 13%.[19] In fact, in 2008, the railroad companies' 12.6%

---

[14] Written Testimony of the Association of American Railroads, *STB Ex Parte No. 677, Common Carrier Obligation of Railroads* (April 17, 2008).

[15] Written testimony of Jeffrey N. Shane, Under Secretary for Policy, Department of Transportation, *STB Ex Parte No. 671, Rail Capacity and Infrastructure Requirements* (April 4, 2007).

[16] *Warren Buffett sees strong rail system as key to U.S. growth*, USA Today (Mar. 25, 2010).

[17] *Burned Before, Railroads Take Risks*, Wall Street Journal (June 28, 2010).

[18] Wolfe, Training Manual at 6.

[19] The accounting measure used to measure profitability in this report is "profit margin" or "return on revenue," which is the percentage of a company's revenues that is net income. AAR and other industry representatives sometimes selectively use another financial ratio, the "return on shareholders' equity," to argue that the railroad industry's profits are modest compared to other sectors. Return on equity measures

profit margin placed the industry fifth out of 53 industries on *Fortune*'s list of "most profitable industries," trailing only the communications, Internet, pharmaceutical, and medical device industries.[20] Between 2001 and 2008, the railroad industry was ranked in the top ten on *Fortune*'s profitability list seven out of eight times. While the railroads were telling their regulators that their profitability trailed most other U.S. companies, they were actually among the U.S. economy's top performers.

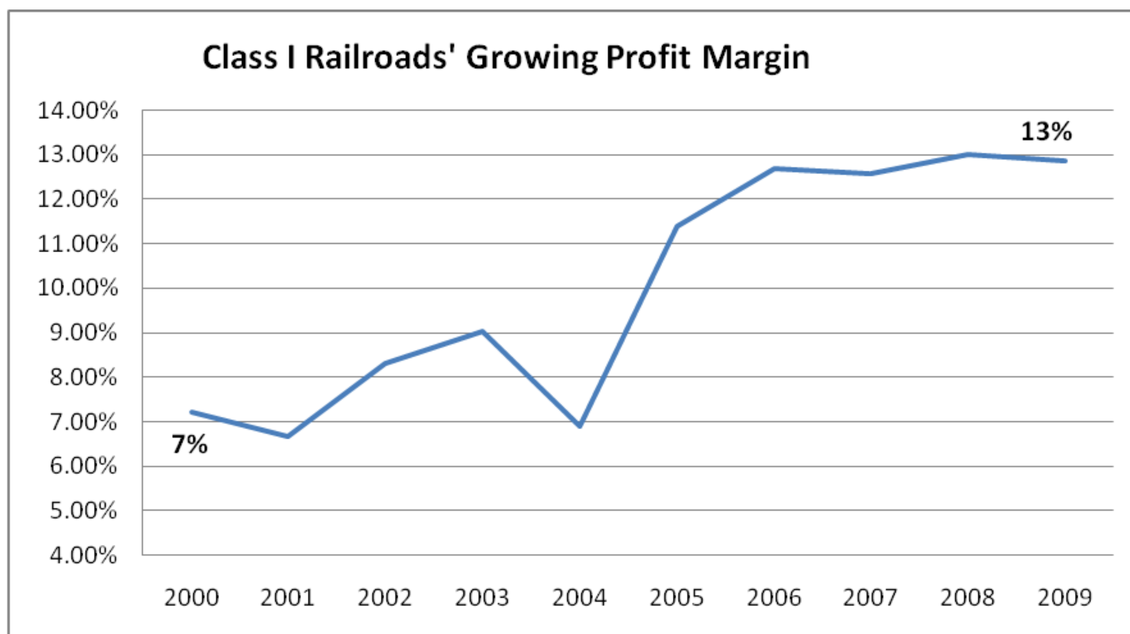

Figure 1 – Combined Profit Margins (Net Income/Revenue) for BNSF, Union Pacific, CSX, and Norfolk Southern, 2000-09 (Source: SEC filings)

III. Investor Interest in the Freight Railroad Industry

The companies' SEC filings over the past decade do not show that the railroad industry is "lagging behind" other industries, as AAR told its regulators in 2008. In fact, the railroads' growth in earnings and profitability has outpaced almost all of the other large industries it competes with for capital in the equity markets. Over the last decade, the large railroad companies have reported higher revenues and stable or only slowly-growing expenses, even during the recent economic recession. This relationship between operating expenses and

---

not all net income, but only the income a company retains from year to year for future growth. Return on equity can be negatively affected by paying dividends or buying back stock. The Class I railroads' recent stock buyback activities are discussed in Section V of this report.

[20] Fortune, *2008's Top Industries: Most Profitable, Return on Revenues* (online at http://money.cnn.com/magazines/fortune/fortune500/2009/performers/industries/profits/) (accessed Aug. 27, 2010).

revenues is known as the "operating ratio," and is an important indicator of financial performance in many transportation sectors, including the rail and trucking industries.[21]

As Figure II demonstrates, railroads have been steadily lowering their operating ratios over the past decade, reaching a ten-year low in 2009. This 2009 result is especially impressive, since it was achieved in the midst of a severe economic downturn.

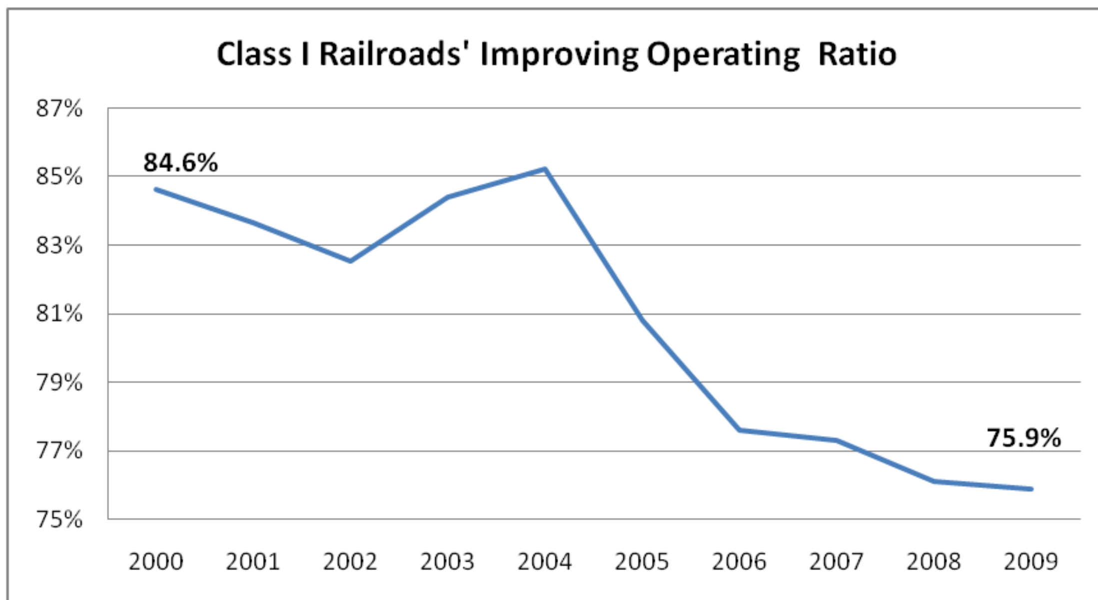

Figure II – Combined Operating Ratios (Expenses/Revenues) for BNSF, Union Pacific, CSX, and Norfolk Southern, 2000-09 (Source: SEC filings)

As the railroad industry's profit margins have risen and their operating ratios have dropped, investors have taken notice. As Figure III shows, the stock value of the four largest rail carriers over the past ten years has far exceeded the average stock value of the large U.S. companies that are part of the S&P 500. An index of large railroad company stocks monitored by Wolfe Research appreciated 119% between 2003 and 2009; the S&P index was down 0.3% during the same period.[22] Recent quantitative stock reports published by Standard & Poor's give quality rankings of "A", "A-", and "B+" to Union Pacific, Norfolk Southern, and CSX, respectively. Union Pacific and Norfolk Southern scored above the 90th percentile on S&P's

[21] *See e.g.,* Testimony of Michael J. Ward, Chairman and CEO, CSX Corporation, U.S. House Committee on Transportation and Infrastructure, Subcommittee on Railroads, Pipelines, and Hazardous Materials, *Hearing on Investment in the Rail Industry*, 110th Congress (March 5, 2008) (H. Rept. 110-104). ("Operating ratio, which is inverse margin or the ratio of operating expenses to operating revenues expressed as a percentage, is a widely used performance measurement in the railroad industry.")

[22] Wolfe, Training Manual at 6.

"Investability Quotient," a measure of an investment's desirability, while CSX received a score of 89%.[23]

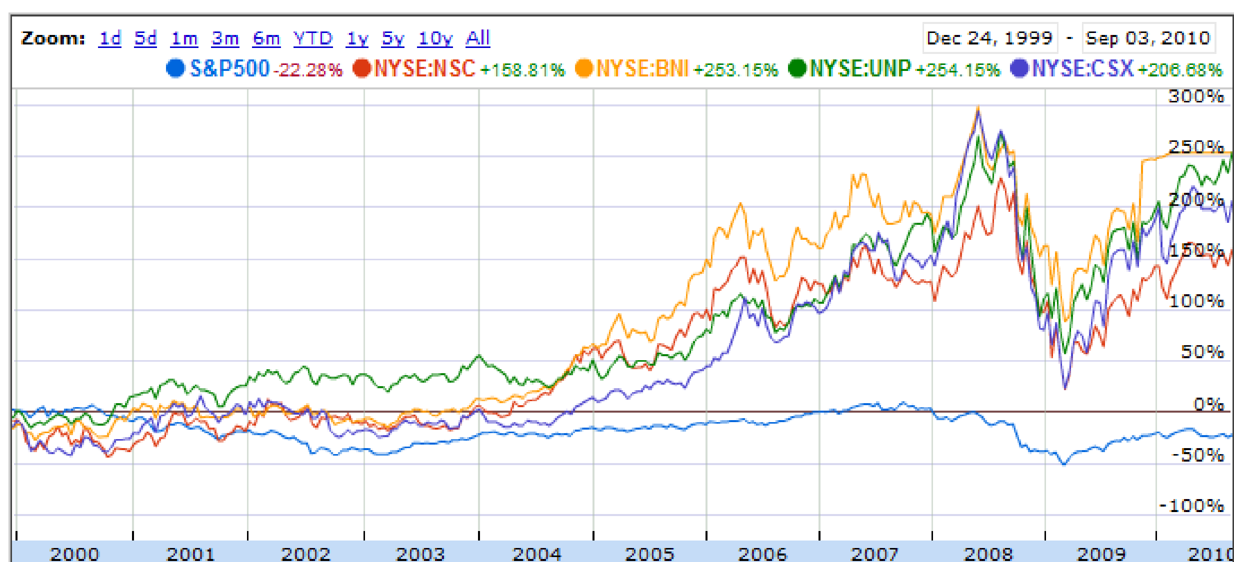

Figure III – Stock Performance of BNSF, Union Pacific, CSX, and Norfolk Southern Compared to the S&P 500 Index, 2000-09 (Source: Google Finance)

In November 2009, the investor Warren Buffett expressed his great confidence in the financial sustainability of the railroad industry by announcing that his company, Berkshire Hathaway, would purchase the 77.4% of the BNSF railroad his company did not already own. The deal was valued at approximately $34 billion, making it the largest ever acquisition in Berkshire Hathaway history.[24]

In discussing his acquisition of BNSF, Buffett said he believed his investment in BNSF would deliver "steady and certain growth" over the coming decades.[25] He also predicted that the U.S. rail industry has a "dynamic and profitable future" and that all four big freight railroads will "do very well" in the coming decades because they are the only mode of freight transportation that will be able to keep up with the American economy's increasing demand for consumer

[23] Standard & Poor's, Union Pacific, *Quantitative Stock Report* (Sep. 4, 2010); Standard & Poor's, Norfolk Southern, *Quantitative Stock Report* (Sep. 4, 2010); Standard & Poor's, CSX, *Quantitative Stock Report* (Sep. 4, 2010). Since its purchase by Berkshire Hathaway (see below), BNSF shares are no longer listed on the New York Stock Exchange.

[24] Burlington Northern Santa Fe Corporation and Berkshire Hathaway, Inc. Joint Press Release, *Berkshire Hathaway Inc. to Acquire Burlington Northern Santa Fe Corporation (BNSF) for $100 Per Share in Cash and Stock* (Nov. 3, 2009).

[25] *Buffett: Railroad business is 'in tune with the future'*, USA Today (Nov. 4, 2009).

goods and raw materials.[26] Analysts suggest that as much as $18 billion poured into the rail industry in the wake of Mr. Buffett's BNSF announcement.[27]

In his annual letter to Berkshire shareholders, Mr. Buffett noted the similarities between the capital-intensive railroad industry and the regulated electric utilities his company already owned. Like electric utilities, railroads "provide fundamental services that are, and will remain, essential to the economic well-being of our customers, the communities we serve, and indeed the nation." He predicted that Berkshire's investment in BNSF would "deliver significantly increased earnings over time, albeit at the cost of our investing many tens – yes, tens – of billions of dollars of incremental equity capital."[28]

IV. Railroad Industry Pricing Power

The railroad industry correctly points out that after the Staggers Act gave the railroads the ability to negotiate prices with shippers, railroad rates dropped significantly. According to the AAR, after adjusting for inflation, rail rates are still lower than they were in 1980.[29] The railroads' presumed inability to raise rates on freight shippers with competitive alternatives has long been the industry's justification for its differential pricing practices. Because they cannot adequately recover their costs from shippers with transportation alternatives, railroads are allowed to charge higher rates to "captive" shippers without alternatives.[30]

One of the recent structural changes that the railroad industry does not highlight is that since 2004, railroads have regained their ability to raise prices on their non-captive customers. One leading industry analyst, Wolfe Research, refers to this change as the industry's "pricing renaissance."[31] As Figure IV demonstrates, for a number of years after the Staggers Act was enacted, rail prices measured against inflation fell by an average of 3.6% a year. Since 2004, however, Class I railroads have been raising prices by an average of 5% a year above inflation.[32] And even during the recent recession, while other modes of freight transportation have cut their rates, the Class I railroads have been able to push year-over-year price increases onto their customers.[33]

---

[26] *Warren Buffett sees strong rail system as key to U.S. growth*, USA Today (Mar. 25, 2010).

[27] *Id.*

[28] Berkshire Hathaway Letter to Shareholders (Feb. 26, 2010) (online at http://www.berkshirehathaway.com/letters/2009ltr.pdf).

[29] Association of American Railroads, *A Short History of U.S. Freight Railroads* (May 2010) (online at http://www.aar.org/incongress/~/media/aar/backgroundpapers/ashorthistoryofusfreightrailroads.ashx).

[30] Government Accountability Office, *Freight Railroads: Industry Health Has Improved, but Concerns about Competition and Capacity Should Be Addressed* (Oct. 2006) (GAO 07-94). See also the discussion in Section I above.

[31] Wolfe, Training Manual at 33.

[32] *Id.* at 35.

[33] *Id.* at 43.

This new "pricing power" has led to significant top-line revenue growth for Class I railroads and has resulted in the swelling profit margins described in the sections above. And according to Wolfe Research, because railroad rates are still below their inflation-adjusted 1980 levels, the freight rail carriers believe they will have a "solid multi-year glide path to continued strong rail pricing hikes regardless of the economic environment."[34] A recent Morgan Stanley analysis of the rail industry notes that in the current environment of strong railroad pricing power, "[r]ate negotiations continue to be difficult for shippers and competition remains minimal."[35]

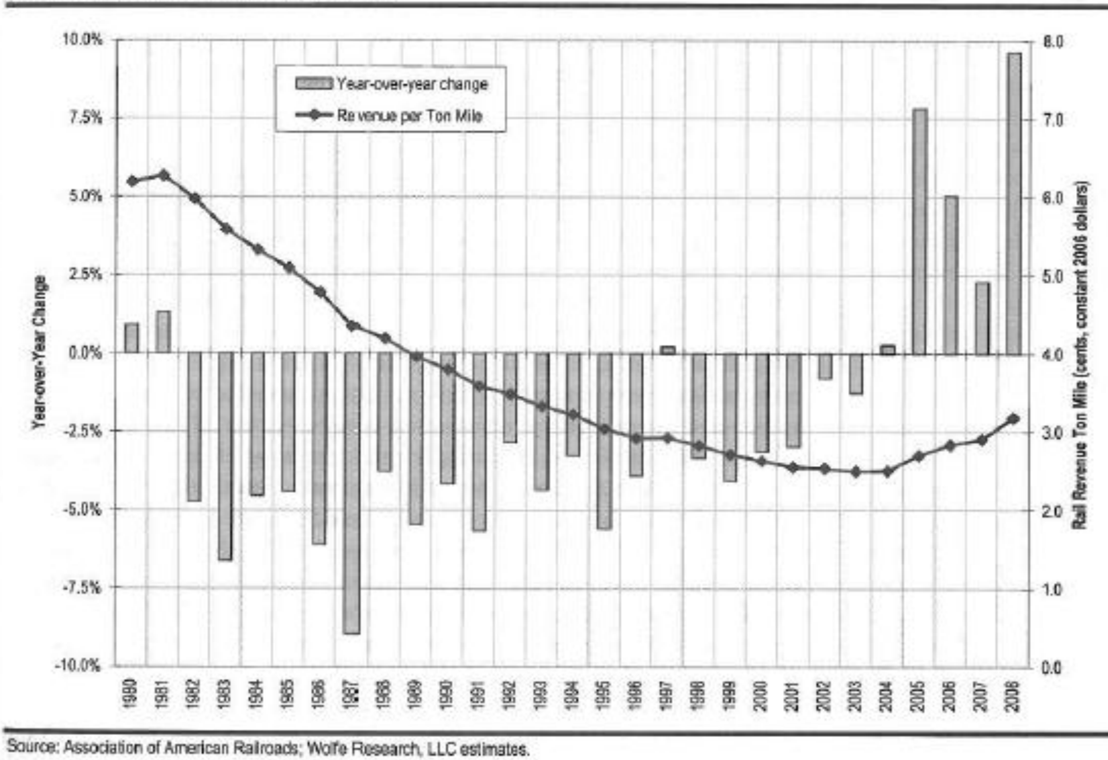

Figure IV- Annual Class I Rail Rates and Revenues, 1980-2008 (Source: Wolfe Research using Association of American Railroads Data)

In recent conversations with their investors, the rail companies have discussed this increase in pricing power and their expectation that it will continue in the future. In a recent investor call, Union Pacific's CEO, James Young, commented, "[t]he pricing environment is stronger today than it's been in a long time…I feel very good about the potential in the pricing

---

[34] *Id.* at 35.

[35] Morgan Stanley Research, North American Transportation, *Freight Transportation: Rails 2Q10 Review* (Aug. 6, 2010).

side going forward."[36] A CSX senior executive, Clarence Gooden, made a similar prediction in his company's second-quarter 2010 investment call, when he said, "[l]ooking forward, we continue to expect core price increases to exceed rail inflation."[37]

A number of factors seem to lie behind the railroads' new "robust pricing environment."[38] Post-Staggers Act industry consolidation and capacity reduction slowly eliminated the excess supply of rails and rail service, while the railroads invested in making their remaining operations more productive. One industry analyst estimates that the railroads moved from a position of "material excess capacity" to "tight capacity" in the late 1990s or early 2000s and that the pendulum has continued to swing further in the industry's favor as demand for rail services continues to grow, particularly in the intermodal, coal, and grain markets.[39]

Another factor that has contributed to the industry's renewed pricing power over the past few years is its shift to short-term contracts with its customers. After the passage of the Staggers Act, during the time they had weak pricing power, the freight railroads entered into long-term contracts with many of their customers. As these so-called "legacy contracts" are expiring, railroads are replacing them with shorter-term contracts—sometimes for terms as short as one year—at significantly higher rates. Shippers also report that railroads are more frequently offering unilateral "take-it-or-leave-it" contracts to customers, a practice that bears more resemblance to setting a tariff rate than establishing a price through negotiation.[40]

Analysts view these expiring legacy contracts as an important source of pricing gains over the next few years. According to Wolfe Research, "[a]s these rail contracts are repriced over the next several years for the first time since the rails gained pricing power in 2004, we believe the rails will be recording material rate increases that could exceed 100% in some cases of very old and underpriced business. (e.g., ten-year old coal contracts)."[41] Morgan Stanley recently rated Union Pacific as its top Class I rail stock based on the fact that the company has the largest percentage of "revenue under legacy contract left to reprice."[42]

---

[36] Union Pacific Corporation 2nd Quarter 2010 Earnings Conference Call (July 22, 2010).

[37] CSX Corporation 2nd Quarter 2010 Earnings Conference Call (July 13, 2010).

[38] Wolfe, Training Manual at 9.

[39] *Id.* at 34-35.

[40] These types of arrangements were the subject of a rulemaking by the STB that was discontinued because consensus on a new rule could not be reached. *See* STB Ex Parte No. 669 (*Interpretation of the Term "Contract" in 49 U.S.C. 10709*); STB Ex Parte 676 (*Rail Transportation Contracts Under 49 U.S.C. 10709*).

[41] Wolfe, Training Manual at 45.

[42] Morgan Stanley Research, North American Transportation, *Freight Transportation: Rails 2Q10 Review* (Aug. 6, 2010).

V. Railroad Industry Capital Investments

Because they have the primary financial responsibility for their rail networks, Class I freight rail companies have both high fixed operating costs and constant needs for capital investments. In addition to the high costs of replacing and upgrading physical assets such as track, ties, and engines, major capital investments are required to expand the capacity of the rail network to address the growing demand for freight rail transportation in the United States.[43] While they tell Congress that they are still not producing sufficient revenue to address their long-term capital needs, a review of the railroads' financial filings and their statements to their investors suggests the opposite.

According to SEC reports filed by the four largest Class I railroads and summarized in Figure V, over the past ten years, the companies made a combined total of $62.5 billion in capital expenditures to replace and upgrade equipment and expand their rail networks. As the companies' revenues grew over the course of the decade, so did their capital investments. The four railroads spent $4.8 billion in 2000 on capital projects, while they spent $7.8 billion in 2009. While these capital investment figures are large, in their public relations materials, the freight railroad industry misleadingly makes them appear larger by adding maintenance costs to capital investments and calling the total "Spending on Infrastructure & Equipment."[44]

The railroad industry has consistently testified before Congress that while it has heavily invested in its network and will continue to do so, it will not be able to completely pay for all of the improvements necessary for freight railroads to meet the long-term capacity demands of the U.S. economy. These investments include upgrading tracks and signal control systems, expanding terminals, and improving bridges and tunnels. In testimony he delivered before the Senate Commerce Committee in 2009, for example, BNSF CEO, Matthew Rose, said that Class I railroads would fall short of paying for their long-term capital investments by approximately $40 billion.[45] A few months earlier, Union Pacific's CEO, James Young, told the House Transportation Committee that "our industry is only investing about half the level DOT studies say is needed to meet the demands on freight rail in the future."[46]

---

[43] The industry is also working to lower its future capital needs by shifting some of its traditional costs to its customers, such as the cost of railcars. In 1987, railcars owned by freight railroad companies moved 60% of tons carried; by 2005, that figure had decreased to 40% of tons carried. Government Accountability Office, *Freight Railroads, supra*, note 30.

[44] *See e.g.,* Association of American Railroads, *Rail Earnings Today Pay for Rail Capacity and Service Improvements for Tomorrow* (May 2010) (online at http://www.aar.org/incongress/~/media/aar/backgroundpapers/railearningstodaypayforrailcapacityandserviceimprovementsfortomorrow.ashx).

[45] Testimony of Matthew K. Rose, Chairman, President and CEO, BNSF Railway Company, U.S. Senate Committee on Commerce Science, and Transportation, Subcommittee on Surface Transportation and Merchant Marine Infrastructure, Safety and Security, *Addressing Surface Transportation Needs in Rural America,* 111th Congress (Aug. 10, 2009) (S. Hrg. 111-490).

[46] Testimony of James R. Young, Chairman, President, and CEO, Union Pacific Corporation, U.S. House Committee on Transportation and Infrastructure, Subcommittee on Railroads, Pipelines, and Hazardous Materials, *Freight and Passenger Rail: Present and Future Roles, Performance, Benefits, and Needs*, 111th Congress (Jan. 28, 2009).

These statements are inconsistent with statements Class I railroad officials make about their capital investments to financial analysts in quarterly conference calls. In these calls, company officials routinely assure analysts their capital investments are sufficient to address future needs. In an investor call in late 2007, for example, the CEO of CSX, Michael Ward, told investors that his company was making the capital investments necessary "to prepare for future growth" and that the company would continue to "generate the cash flow to be able to make capital investment for the future." [47] In an investor call in April 2010, Mr. Young, the Union Pacific CEO, assured analysts that his company was "continuing to make the critical, long-term capital investments that support the Company's growth strategy."[48]

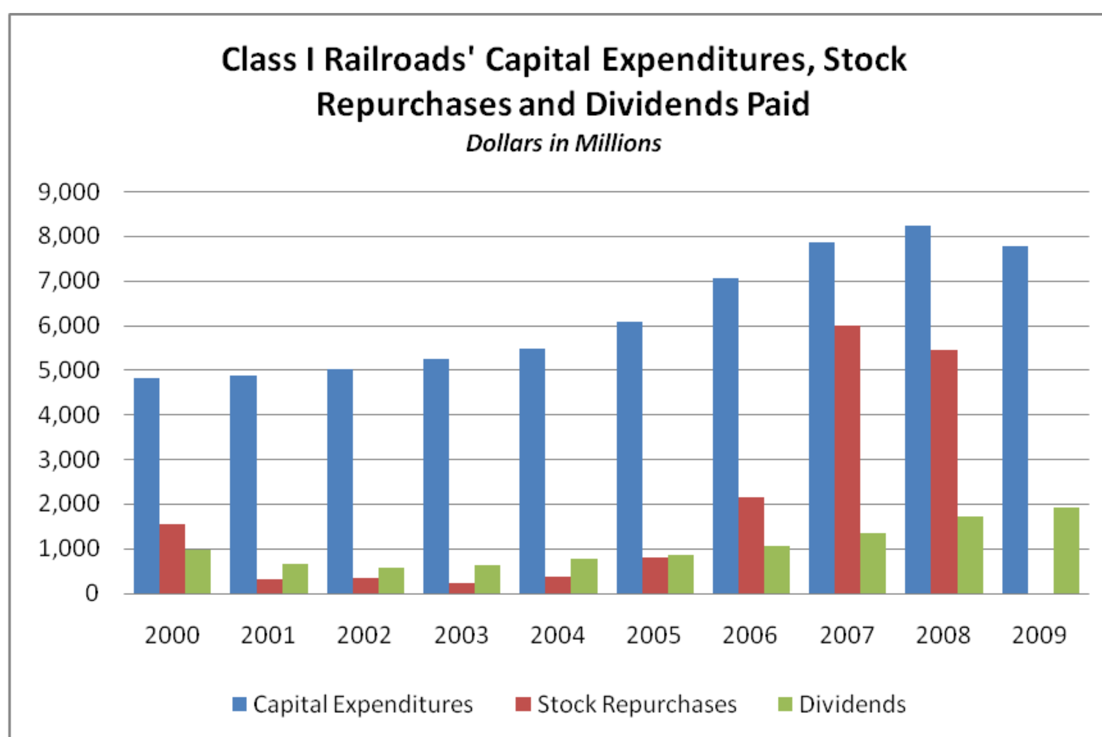

Figure V – Combined Capital Expenditures and Public Stock Repurchases of BNSF, Union Pacific, CSX, and Norfolk Southern – 2000-09 (Source: SEC filings)

Another indication that the Class I railroads believe they are spending sufficient amounts of money on their long-term capital needs is that in recent years, they have used growing portions of their net income to increase their dividend payments and to repurchase their publicly-traded shares. By reducing the number of shares on the market, buybacks have the effect of increasing earnings per share and driving up share prices. The capital expended to buy back shares provides short-term gains in stock value at the expense of investments that increase capacity and productivity. As Figure V shows, the four major U.S. railroads cumulatively spent

[47] CSX Corporation 3rd Quarter 2007 Earnings Conference Call (Oct. 17, 2007).

[48] Union Pacific 1st Quarter 2010 Earnings Conference Call (Apr. 22, 2010).

over $2 billion in share repurchases in 2006, over $6 billion in 2007, and over $5 billion in 2008. Although none of these companies repurchased shares in 2009, they have resumed their share buyback programs in 2010.[49] According to their most recent SEC quarterly filings, CSX, Norfolk Southern, and Union Pacific have already bought back more than $1.6 billion worth of shares in 2010.

Another factor that freight railroads do not highlight in their discussions of their long-term capital needs is that several high-profile railroad capacity projects recently have been financed through a combination of public and private funds. Railroads lobby Congress and state governments for taxpayer contributions to their rail infrastructure improvements and have had a few recent successes in establishing such "public-private partnerships."[50]

For example, public money funded almost 50% of Norfolk Southern's recently completed "Heartland Corridor" project.[51] That project enlarged 28 tunnels along an old coal route, creating a faster and more direct path for double-stack freight trains carrying intermodal freight between the international shipping port in Hampton Roads, Virginia, and Columbus, Ohio.[52] Similarly, Norfolk Southern's rival, CSX, is looking to the states and federal government to contribute more than 50% of the cost of its "National Gateway" project, which will also create a more efficient route for intermodal freight between the Mid-Atlantic ports and the Midwest. CSX has committed $395 million to this $842 million initiative and has received $98 million in federal funding and over $180 million from the states so far.[53]

---

[49] *See, e.g.,* Morgan Stanley Research, North American Transportation, *Freight Transportation: Rails 2Q10 Review* (Aug. 6, 2010). ("Share repurchase activity is accelerating at a number of Class I's – a trend which is likely to add a few percentage points of EPS [earnings per share] growth annually to CNI, CSX, NSC, and UNP").

[50] *See, e.g.,* Testimony of Matthew K. Rose, Senate Committee on Commerce, Science, and Transportation, *Addressing Surface Transportation Needs in Rural America*, 111th Cong. (Aug. 10, 2009) ("As an industry, we're currently spending about $10 billion in the freight rail network. But, if policy leveraged those investments with public partnerships, these investments would happen more quickly, and with more certainty."); Testimony of James R. Young, House Committee on Transportation and Infrastructure, *Freight and Passenger Rail: Present and Future Roles, Performance, Benefits, and Needs*, 111th Cong. (Jan. 28, 2009) ("Congress should enact and fund programs that allow States to partner with freight railroads to move forward with projects that benefit both the freight railroad and the public.").

[51] Norfolk Southern put up $97.8 million for the project, the federal government added $83.3 million, and Ohio and Virginia provided $9.8 million. Associated Press, *Norfolk Southern Opens New $191 Million Route to Midwest* (Sept. 9, 2010).

[52] *Id.*

[53] *Railroads Redraw the Intermodal Map*, Journal of Commerce (Aug. 6, 2010).

Conclusion

Thirty years ago, in order to restore the financial stability of the U.S. rail network, Congress gave railroads the authority to charge captive shippers higher rates than other shippers. Today, the goal of restoring the financial health of the rail industry has been achieved. Class I freight railroads have regained the pricing power they lacked in the 1980s, and are now some of the most highly profitable businesses in the U.S. economy. The railroads have high levels of capital investment and consistently produce strong results for their shareholders throughout the economic cycle. As Congress and the federal government look to the nation's rail system to meet the United States' future transportation needs, they also need to evaluate whether our country's current rail policy needs to be changed to reflect this new reality.