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BEFORE THE
SURFACE TRANSPORTATION BOARD

EX PARTE No. 775
HEARIN ON GROWTH IN THE FREIGHT RAIL INDUSTRY

TESTIMONY OF
AMERICAN FUEL & PETROCHEMICAL MANUFACTURERS

I. Introduction

Chairman Primus, Members Fuchs, Hedlund, and Schultz, thank you for providing this opportunity to testify before the Board, and to weigh in on this important issue. With over 140,000 miles of track in the United States ("US"), the freight rail network is responsible for approximately 40 percent of the US long-distance freight ton-miles traveled.[1] Virtually every aspect of the US economy including the manufacturing, agricultural, and energy industries depend on the freight rail network to provide reliable and affordable service so they can remain competitive in a global market. Collectively, these industries and others account for more than 7 million jobs and contribute more than $4.8 trillion in economic output.[2] These numbers demonstrate that while the focus of today's hearing is on the growth in the freight rail industry, this hearing is about broader economic growth and prosperity. To put it simply, a healthy freight rail network is a critical element of a thriving US economy.

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[1] *See* US Bureau of Transportation Statistics, Dr. Jean-Paul Rodrigue - Hofstra University, American Association of Railroads, US Surface Transportation Board, Canada Carriers Information Regulations, Statistics Canada
[2] *See* Rail Customer Coalition - About Us

II. Economic Contributions of the Refining and Petrochemical Industries

American Fuel & Petrochemical Manufacturers ("AFPM") is the leading trade association representing the makers of the fuels that keep us moving, and the petrochemicals that are the essential building blocks for modern life. The fuel and petrochemical industries contribute hundreds of billions of dollars to the US economy.

AFPM, in coordination with Oxford Economics, recently completed a report entitled "*The Economic Contribution of US Petroleum Refineries*" which measured the economic impacts of US refineries. The report found that in 2022, the Gross Domestic Product ("GDP") contributions of the petroleum refining industry totaled $688 billion (direct, indirect and induced impacts). In 2022, the full economic contribution of the petroleum refining industry measured in terms of employment was nearly 3 million jobs. Petroleum refining is a capital-intensive industry and from 2019 to 2021, US refineries invested on average $9 billion per year, equivalent to 10 percent of the industry's direct GDP, to maintain, upgrade and grow refinery operations. This was the highest capital investment share of GDP of any major manufacturing industry.

In addition to supplying US demand for transportation fuels and other products, US refineries are major suppliers of refined products to the growing global market. Since 2011, the United States has been a net exporter of refined petroleum products, and in 2022, the US exported 91 billion gallons of gasoline, diesel, jet fuel, and other refined products to 150 countries, contributing $102 billion to the US balance of trade, making a sizable positive contribution to the US trade balance.

Our petrochemical manufacturers are strengthening US manufacturing as well and make significant economic contributions to the US economy. While AFPM is currently finalizing an update to our report on the economic contribution of US petroleum manufacturers, our most recent

data tells a similar story as the refining sector. Our petrochemical manufacturers contribute more than $220 billion to the US economy and support over 1.4 million jobs. Petrochemical manufacturers made more than $12.5 billion in capital expenditures in 2017 alone and with new facilities and expansions announced investment continues. Plentiful and affordable natural gas supplies have fueled the petrochemical industry expansion in the US, resulting in over 300 new chemical industry projects. With these expansions the economic benefits will continue to grow.

III. Importance of Rail Transportation to the Refining and Petrochemical Industries

The economic contributions and planned growth associated with the refining and petrochemical industries are dependent on the ability to move products and feedstocks reliably and efficiently to, and from, their facilities. Refineries and petrochemical manufacturers rely on a healthy rail network as a vital part of their supply chains and in turn our industry's growth strategy. Annually in the United States, over 2.3 million carloads of our members' feedstocks and products, including crude oil, natural gas liquids, refined products, plastics, and synthetic resins, are transported by rail.[3] In fact, on average over the last decade 214 million barrels of crude oil, the main feedstock our members rely upon, are moved annually on railroads.[4] AFPM members are increasingly using rail to support renewable energy and recycled plastic projects through the shipment of renewable feedstocks, renewable fuels and recycled plastics. These are rapidly growing segments of our business, which are heavily reliant on reliable and competitive rail service that can grow and meet customer demand.

Transportation and distribution costs account for a significant portion of the overall price a consumer pays for gasoline or petrochemical-based products. For example, transportation costs

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[3] *See* American Association of Railroads - Data Center
[4] *See* Energy Information Administration - Crude by Rail Movements

account for approximately 12 percent of the price a consumer plays for a gallon of gasoline.[5] And while a gallon of gasoline as an illustrative example, this isn't just about gasoline, our members make renewable fuels, jet fuel, diesel, and petrochemicals that are in numerous daily products and that are critical to a myriad of industrial supply chains.[6]

To complicate matters, approximately 75 percent of refiners and petrochemical manufacturers are only served by a single railroad, with no other feasible transportation options that can efficiently move large volumes of feedstocks and products. Being a "captive" shipper amplifies the negative impacts of poor service and limits opportunities for growth. To this end, freight rail service issues that elevate transportation costs impact our members ability to grow their business, which can ultimately result in higher costs for consumers.

IV. The Current Class I Railroads' Operating Model Has Reached an Inflection Point

In 2017 CSX railroad became the first Class I Railroad to introduce Precision Scheduled Railroading ("PSR") in the US and since then it spread to all Class I Railroads. AFPM members initially recognized the potential benefits of the operating model if implemented correctly and balanced with an appropriate focus on customer service. At the same time AFPM members expressed their fears and concerns of what significant cuts in railroad operations and staffing associated with PSR would do, particularly when these leaned operations would encounter adverse situations. As PSR has become ubiquitous in our already competition-constrained rail network, rail shippers are faced with compounding adversity. Class I Railroads abandoned the balance between customer service and efficiency as Class I Railroads are currently primarily driven by lower

[5] *See* Energy Information Administration - Gasoline Explained
[6] *See* AFPM.org - Rail Strike Impacts Will by Felt Quickly

operating ratios without sufficient regard for the impact such cuts would have on customers' ability, or desire, to increase rail traffic.

The spread of the PSR operating model across the Class I Railroads is a key contributing factor to the current service issues we are facing and limits the refining and petrochemical industry's ability to grow freight rail traffic. In fact, recent studies by the Government Accountability Office and US Department of Transportation recognized the negative impact PSR has on railroad resiliency and that industry's ability to respond to supply and demand fluctuations.[7] The PSR operating model has driven operating ratios to levels once thought impossible. To achieve these sub-sixty percent operating ratios, Class I Railroads have slashed their workforce, shuttered facilities, shelved equipment and reduced service to the detriment of their customers. These are not pro-growth stimulating actions, and it should come as no surprise that this has benefited investors but harmed rail shippers' ability to grow their business.

Class I Railroads have dictated all these changes to rail customers with short notice, sometimes just days, and with limited or no negotiation. AFPM members have experienced increased rates, reductions in service days, the closure of hump yards and storage facilities vital to our operations, an increase in missed switches, and many other service issues. Our members have gone as far as making critical capital investment decisions based on where they can secure competitive rail service. Our members have acquired, leased or built additional storage yards and purchased or leased additional tank car assets to counteract the negative impacts of PSR. In this operating environment, it is hard to grow freight rail shipments when railroads effectively force AFPM members to make investments just to maintain existing service levels. AFPM hopes Class

[7] *See* US DOT Sectoral Supply Chain Assessment (February 2022) and Freight Rail: Information on Precision Scheduled Railroading (December 2022).

I Railroads will put a greater focus on customers and provide the confidence that the rail network can grow with their customers business.

According to many industry analysts PSR has reached an inflection point. Specifically, the implementation of PSR has reached a point of diminishing returns where each percentage point decrease in operating ratios is returning less for investors and harming customers more.[8] With the decrease in operating ratios, and poor service accompanying it, we are likely to see more customers reach a breaking point and look at other transportation alternatives or be forced to decrease output. Refocusing on customer service would give shippers the confidence they need to grow existing rail shipments or even switch other modal shipments to rail where feasible.

V. Railroads' Market Dominant Position Hinders Growth

In a competitive market, to increase rail volumes and in turn grow, railroads would simply need to deliver sustained service quality and a customer experience better than their competitors. Unfortunately for most rail shippers the rail market is not competitive as our industry is predominately served by only regional monopoly railroads. Furthermore, other modes are often not available or feasible to ship large volumes of products or feedstocks long distances needed to access markets. The following three examples demonstrate how Class I Railroads' actions are stifling growth in rail traffic and in turn the petrochemical and manufacturing industries.

A. Rail Service Challenges

Class I Railroads present their customers with a take-it-or leave-it scenario when it comes to service. Even though railroads have a common carrier obligation, they require shippers to agree

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[8] For example *see* Taking the Railroad Playbook Beyond PSR published March 13, 2020 by BCG - Dustin Burke, Rodrigo Garcia Escudero, Cornelius Pieper, and Tyler Barrack and The Path to Long-term Shareholder Value for Rail is Growth by OliverWyman - Matthew Schabas and Adriene Bailey

to unreasonable and one-sided language in the carrier's industrial track agreements before the railroads provide service. Railroads dictate service days and change those frequencies with little notice. Such short notice and lack of consistency interrupts operations and makes it difficult for our members to grow. One AFPM member cited a Class I Railroad's reduction in service days paired with their refusal to invest in infrastructure as the reason that member could not startup a new asset, limiting their ability to grow that manufacturing location.

Rail shippers have no real recourse for missed or delayed shipments, which is a frequent occurrence. AFPM members frequently suffer large financial losses due to lack of railroad performance with no compensation from the carrier that caused the losses. Each Class I Railroad has a customer service case management system that flags delayed shipments and other service issues that negatively impact and even could shut down a manufacturing facility. AFPM members report that the local operating personnel have expressed that there are so many customers serviced flagged issues it is not possible to respond to most requests rendering calls to customer service is a non-value-added activity.

Rail shippers seeking to expand existing rail volumes or add new lines of business must deal with the Class I Railroads understaffed customer service and business development departments. Opportunities are frequently presented but usually declined by the Railroads operating departments. Even when operating departments agree to new service, the railroads contractual demands and one-sided liability requirements give many shippers pause. The barrier to entry for new business is incredibly burdensome as rail shippers must navigate a complex process with the railroads' industry development group just to propose potential new shipments. This is an exhausting endeavor for a seasoned transportation team and an impossibility for a hypothetical new business entity that would like to entertain new rail service. This further

complicates AFPM members' ability to plan and optimize existing operations, let alone grow those operations and calls into questions Class I Railroads desire to increase rails volumes.

B. Shipping Rates and Contract Negotiations

The take-it-or-leave-it mentality also applies to shipping rates and private contracts. Given the onerous and lengthy process of challenging a tariff rate with the Board, railroads are at an advantage. Railroad's strategically price private contracts to entice shippers to avoid tariff rates, but then include various provisions that are tremendously advantageous for the railroads at the expense of their rail shipper customers. For example, Class I Railroads almost universally and explicitly reject performance terms and conditions in their contracts given their leverage. If the railroads won't add such performance assurances to their contracts, the contract becomes nothing more than a price document. The only alternative for shippers is to choose a higher tariff rate, and then begin a costly and lengthy proceeding to challenge that rate with no assurances of success or reimbursement for the full cost incurred.

In competitive markets transportation carriers structure their annual increases on customer shipping rates to track closely with broader inflation rates and are in line with other "competing" modes increases to avoid risking market share loss. This is not the case with rail transport. Class I Railroads' rate increases far outpace inflation and their modal competition.[9] Further, rate hikes are far more frequent in rail transportation compared to other modes. Such rate hikes give rail shippers pause when considering growing rail volumes.

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[9] Between 2000-2020 rates for the largest U.S. railroads have jumped more than twice as fast as inflation and rates for long-haul trucking. See also AFPM Blog - Freight Rail in America: Can a Market Be 'Free' if There's Almost No Competition?

C. Rail Liability Provisions

AFPM members have experienced railroads using their bargaining power in contract negotiations over captive shippers to include unfounded liability and indemnification provisions in private contracts. Such requirements effectively absolve railroads from any, and all, liability and require rail shippers to accept responsibility for actions beyond their control. Railroads, as part of these contracts, are also now requiring rail shippers to increase their levels of insurance for certain hazardous materials shipments. In a recent instance, a Class I Railroad required rail shippers to increase their insurance coverage by 10X (from $10 million to $100 million in liability coverage) and gave them just a month to do so. When AFPM members entrust their products to rail carriers, there is an expected duty of care and vigilance and when railroads fall short of their duty, rail shippers should not be left shouldering the liability for someone else's negligence. With these liability provisions rail shippers may seek transportation modes where carriers do not force them to assume the liability of those carriers and actions beyond rail shippers' span of control. The cost of these additional forced liability also will impact rail shippers' ability and willingness to invest in new business with a rail carrier.

VI. A Path Forward to Promote Rail Growth

To address these challenges AFPM suggests the following solutions that could foster growth for both the railroads and the customers that rely on rail:

A. Reintroduce Competition in the Rail Markets

Competition as a key pillar of a strong and well-functioning US economy. Basic economic theory demonstrates that when industry participants must compete for customers, it leads to lower

prices, higher quality goods and services, greater variety, and more innovation. The Board has the potential to directly encourage economic growth in the rail sector, and the broader economy, by using its' authorities to promote competition in rail markets. While the Board has made strides to address competition more can and must be done.

Specifically, the Board's decade long pursuit of implementing reciprocal switching regulations has the potential to increase competition and foster a more pro-growth environment for both railroads and the customers that rely on them. Unfortunately, the recently published final rule on reciprocal switching represents a missed opportunity to address freight rail problems. The STB's final rule allows shippers to seek reciprocal switching when their current railroad fails to meet specific service performance metrics. The rule specifically excludes any rail traffic that is moved under a contract rate, preventing most rail customers from accessing competitive rail service. As some on the Board have noted the final rule is "unlikely to accomplish what the Board set out to do" because the rule will not help most rail customers that receive substandard service. This includes an overwhelming majority of AFPM members whose traffic mostly moves under contract rates.

AFPM strongly believes reciprocal switching should be available when there is a lack of competition, which is the harsh reality for more than three quarters of the rail market. In the absence of broad access to reciprocal switching based solely on lack of competition, a service-based approach would be practicable, in the public interest, and could provide benefits if crafted carefully with targets that incentivize improved service, rather than codifying the poor service of the past. AFPM also believes applying reciprocal switching, or at least the service metrics associated with them to contract rates is essential given railroad's considerable market dominate position when negotiating private contracts. The Board should use such metrics as grounds for

prescribing a reciprocal switching arrangement that would become effective after the contract expires.

We urge the Board to advance proposals that would fully implement Congress' vision of reciprocal switching as a tool to promote more effective rail competition including efforts to clarify the Board's authority to apply this rule to contract traffic. As you are aware this rule was immediately challenged by the Class I Railroads and despite our disappointment in the final rule, we encourage STB to fight to keep the rulemaking intact as it represents a first step in the right direction to improve competition.

B. Revise the Common Carrier Obligation to Reflect Current Market Failures

Since the passage of the *Staggers Act* in 1980 the freight rail market has transformed and evolved dramatically. For example, the number of major railroads have condensed from over forty to now just six railroads and rail car ownership has shifted almost entirely from railroad-owned cars to shipper-owned or leased cars. Further, PSR has negatively transformed the quality and type of rail service rail customers receive. As is the case in many instances, regulatory policy does not always keep up with changes in the industry regulated. As defined in the *Staggers Act* the "common carrier obligation" requires that rail carriers serve the wider shipping public "on reasonable request." Clearly defining this ambiguous principle has taken on greater importance as the railroad industry's focus has shifted from providing good service to their customers.

AFPM urges the Board to undertake a review of the common carrier obligation and provide needed clarity on what a "reasonable request for service" is, and what minimum standard of service a railroad must provide. An assessment of the railroads' common carrier obligation and the associated regulations would also include recommendations on necessary changes (including

expanded Congressional authorities) and improvements needed to drive growth in the freight rail industry. This effort could be set up like the "Rate Reform Task Force" that was established in January 2018 to develop recommendations to reform and streamline the Board's rate methodology and review process.[10] Given that "reasonable service" is critical for rail growth and is at the heart of determining whether common carrier obligations are being fulfilled, we believe this is a logical approach.

C. Fright Rail Partnerships and Collaborative Relationships

The last solution AFPM suggests requires no direct action by the Board. AFPM members are hopeful the railroads, their customers and other stakeholders can rebuild their relationships that have been negatively impacted in the wake of the implementation of PSR. To this end, we call on Class I Railroads to return to a customer focused operating model that prioritizes communication and transparency. This should be a collaborative relationship where our industries work together to grow and put long-term shared business benefits ahead of individual short-term profits. This would include open lines of communication demonstrated by early notification and discussions regarding changes in service levels or rhythms.

As a recent report by the Michigan State University and supply chain consultancy Maine Pointe notes the "future of the freight rail industry depends on the rail companies actively listening to shippers and other members of the transportation eco-system in order to come up with win-win scenarios – until they do that, there will be stalemate" regarding growth.[11] AFPM members are

[10] *See* STB - Rate Reform Task Force
[11] *See* Rail Optimization White Paper: The Future of Rail published by Michigan State University's Center for Railway Research and Education in association with Maine Pointe

willing to have these dialogues with their service providers and find compromises to drive freight rail growth.

VII. Conclusion

Recent changes to railroads' operating models have left their customers behind. While this initially increased operating efficiencies, the freight rail network reached a point where efficiency gains have been exhausted and the changes are now hindering further growth in rail traffic. Despite these challenges railroads and rail shippers still have a shared and vested interest in growing the US freight rail industry and in turn the US economy. The Board can and should implement pro-growth and pro-competition regulatory policies that can benefit all. AFPM appreciates the Board's attention on this important issue and its consideration of AFPM's comments.

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