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Effects of Disclosure Requirements on Railroad Grain Transportation Contracts

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16. Abstract

The Staggers Act of 1980 legalized confidential rail/shipper transportation contracts. Their acceptance by railroads and shippers is best demonstrated by the exponential growth of these contracts through the 1980s. In 1986, Congress mandated considerable disclosure in transportation contracts for grain, in response to the demands of some segments of the grain industry. With increased disclosure, the number of contracts began to decline although the volume moving under contract remained about the same. This report analyzes the impacts on railroad grain shipments brought about by Congressionally mandated disclosure rules covering railroad grain transportation contracts. It explores how the disclosure rules affected the propensity of railroads and shippers to enter into these contracts. It examines whether increased disclosure was responsible for the decrease in the number of contracts entered into, and whether disclosure affected the efficiency of grain movements and rail operations. The report also discusses how the different railroads crafted contracting policies to conform to their competitive position in the grain transportation industry.

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EXECUTIVE SUMMARY

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This report analyzes the market impact of contract disclosure rules affecting the transportation of grain by rail. The report is divided into seven chapters. The first three chapters provide the background necessary to understand contract disclosure and to assess its impact on the commercial strategies of railroads in the post-Staggers era. These strategies are discussed in detail in the fourth chapter. The impact of contract disclosure on the railroads and shippers is analyzed in the three chapters that follow. Chapter 5 focuses on carrier impacts. Chapter 6 focuses on shipper impacts, and finally, chapter 7 on the net effect of contract disclosure.

Background

The Staggers Rail Act of 1980 allowed railroads and shippers to enter into binding contracts. It also required summary disclosure of the contract terms for all commodities moved under rail contract. The legislation set in motion a series of Interstate Commerce Commission (ICC) proceedings to establish procedures for contract filing, for contract approval, and for specific information to be contained in publicly available contract summaries on file with the ICC. Significantly, the Act established more exacting disclosure requirements for agricultural commodities than for other commodities, as well as an expanded basis under which affected agricultural shippers could challenge contract legitimacy. During the period 1980 to 1986, the ICC issued several sets of rules affecting contract disclosure. From its legislative inception, contract disclosure remained highly controversial and the subject of intense debate regarding its interpretation. Indeed, Congress returned to the issue of grain contract disclosure six years after it originally mandated disclosure in the Staggers Act to add new disclosure requirements in the Conrail Privatization Act of 1986. This Act clarified the information requirements that applied to grain contract disclosure and directed the ICC to provide more "liberal" discovery to grain shippers who seek remedies from "discriminatory contracts" than the Commission had previously allowed. In March 1988, the Commission issued

a set of final rules, which complied with the Conrail Privatization Act (Pub.L. 99-509). These rules stand today.

Contract disclosure was intended as a mechanism to assure the efficient operation of grain transportation markets and to further assure that the interests of small grain shippers were balanced against the economic forces deregulation had released -- forces that drove rail grain contracting toward low cost/high volume formats soon after deregulation.

Rail deregulation and the freedom to contract for grain services were introduced into a notably soft market -- a "buyer's market." Rail carriers began their experimentation with the new freedoms that the Staggers Act allowed during an extended period of sharp retraction in U.S. grain export activity and a period of relatively slow growth in domestic consumption. During this time, volatility increased measurably in world grain prices as more grain production came into the world market and as U.S. farm policy increasingly exposed U.S. producers directly to foreign price competition. Also, during this period, federal farm subsidy and storage programs increasingly affected domestic grain markets. These and other factors influenced the commercial strategy development of individual carriers. Separating external market effects from the effects of regulatory reform itself is complex. Both factors clearly influenced the market strategy development of individual rail carriers in the 1980's.

As a direct result of the Staggers Act, rail contracting activity in grain markets began to increase gradually in 1981 and 1982 from a minimum base. Grain contracting activity increased markedly in 1983 and 1984 and even more rapidly in 1985 and 1986. Contracting activity peaked in 1986 and then fell off in subsequent years from the 1986 high water mark.

During the 1980's, demand for rail grain service increased by 34% from 1978 to 1988. In spite of this absolute increase in rail grain tonnage, supply/demand capacity imbalances persisted in favor of the demand side during most of the decade. It was not until late 1987 and 1988 that surplus car capacity was eliminated and rail rates began to trend upward for the first time in the decade.

Evolution of Carrier Grain Commercial Strategies

The Staggers Rail Act gave railroads greater freedom to set rates and to explore new commercial paradigms for marketing their services. In the broadest terms, the Act allowed carriers to shift their commercial emphasis from tariff based commercial mechanisms that afforded the same rates to all shippers within broad geographical rate territories, to other commercial paradigms -- paradigms more tailored to the needs of specific customers and less open to public scrutiny.

Shifts in these commercial paradigms had significant effects not only on grain shippers but also on other grain market participants. Over an extended period of time, before the Staggers Act, relative price relationships implicit in origin territory to destination territory tariff rate structures had become the "basis" for establishing the delivered price of grain. In adapting their commercial strategies, individual rail carriers steered between the dual constraints of maintaining non-distorting grain market mechanisms and the need to profitably adapt commercial policy to the local market over which they operated.

The development of a commercial strategy in the open, post-Staggers environment has been an evolutionary process for most carriers, a process of trial and error. Indeed, the grain marketing strategy of many carriers has evolved through a multi-phased learning process. In this process, carriers have learned not only from their own commercial experience but also from the experience of other, sometimes competing, carriers.

As a broad generalization, which fits no individual carrier perfectly, this process of commercial evolution has progressed in three recognizable phases: 1) An initial experimental phase was characterized by aggressive pricing, by the testing of the new contract freedom, and by a painstaking re-assessment of the needs and requirements of each service franchise. During this phase, carriers scrambled to lock-in business and to exercise their newly acquired contracting freedoms aggressively in an effort to increase market share. Phase one was a competitive free-for-all. 2) A second phase was characterized by the development of formal commercial strategies designed to match the

characteristics of each railroad's market. During this second phase, individual railroads developed and implemented distinct marketing programs based on market segmentation strategies, pricing policies and commercial standards for contracting -- all adapted to the specific markets in which they operate. 3) The third phase of market development, which is only now beginning, is marked by competitive emulation, commercial strategy refinement, and contract simplification. The principal objective of most carriers in phase three will be to improve profitability, either through incentives designed to encourage equipment utilization, or to increase revenue yields.

The single clearest message that emerges from a close review of post-Staggers Act commercial strategy is the diversity of individual carrier strategies and the close fit between a carrier's marketing programs and the market underlying its service system.

Individual carrier commercial strategies vary in a number of essential ways. Most importantly they vary in the strategic objectives they are designed to achieve. Several rail carriers have set as strategic objectives the leveling of demand in highly volatile export markets. Other carriers have set as objectives the development of new on-line processing industries or the opening of new offline markets previously closed to their origin elevators. Still other carriers have attempted to use contracts to enhance the value and the end-market access of their origin elevators.

Effects of Contract Disclosure

The broad grounds for redress provided to agricultural shippers in the Staggers Act, combined with contract disclosure, gave shippers additional leverage in contract negotiations with rail carriers. Moreover, the threat of disclosure litigation influenced many carriers to formalize their marketing programs independent of the use of that threat by shipper negotiators. The results of disclosure in the post Staggers era were fourfold:

- ***Downward Price Pressure** - The threat of secondary disclosure allowed shipper contract negotiators to exercise additional leverage in negotiating lower rate levels. Contract rates tended*

to find a lowest common denominator in an environment in which contract data was broadly disseminated.

- ***Formalization of Marketing Programs*** *- The ICC's final rules on contract disclosure tended to accelerate the process of marketing program formalization. Marketing programs that explicitly identified a threshold basis for contract holder qualifications and that further provided standard terms and conditions for contracts of specific types, became the bulwark behind which individual carriers could defend their practices as non-discriminatory.*

- ***Accelerated Movement toward Receiver-Oriented Contracts*** *- Receiver programs quickly came to dominate the rail industry. In part, this development resulted from the fact that receiver programs are inherently less discriminatory. Most rail carriers discovered early in their experimentation with grain contracting that negotiating similar contract terms among origin elevators is an impossible task. Most discovered, at the same time, that effective traffic control typically resided with the receiver, not the shipper.*

- ***Reduced the Number of Outstanding Contracts*** *- The clear result of contract disclosure has been a marked reduction in the number of grain contracts. While the total number of all rail contracts continued to increase in 1987 and 1988, the number of grain contracts fell sharply. In part, this resulted as some roads moved away from contracts (e.g. Soo Line and Burlington Northern). In part, it was the result of roads moving to receiver contracts that are typically larger and more encompassing. No evidence exists, however, that the total volume of grain moving under contract has declined.*

Most carriers modified their commercial strategies in the period 1986 to 1988, at least in part, to minimize contract disclosure liability. For example, most carriers formalized their contracting programs during this period and in formalizing their programs established terms that applied evenly to all qualified contract participants. Many railroads have, more recently, begun to shift their pricing dependence marginally toward tariffs and away from contracts. Other carriers are closely monitoring the regulatory status of Burlington Northern's Certificate of Transportation (COT) programs. The future of grain contracting may well evolve in the direction of COTs. By the end of the 1980's, only a few railroads continued to use contracts to segment markets and to leverage volume

commitments from large shippers.

Shipper Perceptions of Contract Disclosure

Most shippers agree that contract disclosure and contracting practices generally have worked well since disclosure became fully effective. A period of testing and interpretation from 1986 through 1987 has been followed by a period of refinement in the protection that contract disclosure affords grain shippers. Importantly, the period that has elapsed since the implementation of the Staggers Act has principally been a buyer's market. Only since 1987 have grain transportation markets tightened. During this period, rail carriers have been more receptive to suggestions from shippers regarding the direction of their commercial strategy than might have been the case if markets had been "tighter." In any case, most shippers appear to agree that contract disclosure and contracting practices of individual rail carriers have generally worked well. Some of the more significant effects of contract disclosure that shippers noted include the following:

- ***Stimulated Carrier Innovation*** *- The exposure associated with grain contracting and disclosure has encouraged railroads to find innovative alternatives to contracts. The best example of this is the BN's COTs program which was, to a degree, influenced by BN's desire to avoid the exposure associated with the contract disclosure rules*

- ***Receiver Contracts*** *- The process has accelerated the trend towards receiver contracts. Although the total amount of grain moving under contract has not changed over the past few years, the number of contracts has declined and the volume per contract has increased. Typically, receiver contracts tend to be for larger volumes than shipper contracts.*

- ***Rate Equality Among Shippers*** *- The disclosure process has tended to produce greater equality in rail rates for movement of grain. To avoid exposure from the disclosure rules, railroads have in many cases moved to receiver contracts, or to tariffs, or are giving the same rate for similar moves (single car, multiple cars, unit trains, etc.), in the absence of volume commitments, to all contracting shippers/receivers.*

FRA RELEASES STUDY ON IMPACTS OF
RAILROAD GRAIN CONTRACT DISCLOSURE

The Federal Railroad Administration released today a report--Effects of Disclosure Requirements on Railroad Grain Transportation Contracts--finding that increased disclosure requirements have had a significant effect on rail grain markets.

The study found that railroads modified and formalized their marketing programs to minimize their exposure to shipper complaints of discriminatory behavior. As a result, increased contract disclosure equalized rates, encouraged railroad marketing programs toward receiver-oriented contracts, and, in some cases, caused carriers to move away from contracts entirely.

Grain shippers generally believe that increased disclosure stimulated carrier innovation, accelerated the trend toward receiver contracts, and produced greater equality in rail rates for the movement of grain.

The Staggers Rail Act of 1980 explicitly legalized confidential rail-shipper transportation contracts, requiring that only the most general terms be available for public review. In 1986, Congress mandated considerable disclosure in rail transportation contracts for grain in response to the demands of some segments of the grain industry. These shippers felt they could lose potential markets if a competing shipper were able to negotiate contracts with the serving railroad at more favorable terms, while, at the same time, the contracting railroad would not grant them similar contract provisions.

The law required additional contract provisions to be disclosed in the contract summary sheet filed with the Interstate Commerce Commission. These included shipper identity, transit points, contract duration and optional extension, and actual volume information.

The number of rail contracts filed at the Interstate Commerce Commission for transporting grain has dropped significantly since the new rules were adopted, although the amount of grain moved under contract has increased.

The results of the study, which was conducted by Transmode Consultants, Inc., are based on interviews with officials of major grain hauling railroads and both large and small grain shippers.

Copies of the final report and appendices will be available from the National Technical Information Service, Springfield, Va., 22161.

- ***Minimal Administrative Cost*** *- Disclosure rules imposed no additional cost on shippers, and a minimal amount on railroads. The major administrative burden on railroads is the filing of contract summaries.*

- ***Willingness to Contract Unimpaired*** *- Shippers generally believe that changes in the contract disclosure rules have not had any effect on their willingness to enter into contracts, to move freight by rail, on availability of covered hoppers, or on the costs of transportation.*

Changes made to contract disclosure requirements in 1986 produced many of the results that Congress intended. Considerable support appears to exist within the shipper community for the contract disclosure requirements that are in place today. Both shipper and carrier responses in interviews indicated that even though some carriers would like to scrap or change the rules, the rules are working and have achieved their intended objectives. Still, many respondents feel that redundant reporting requirements and commercially valueless information in the contract summaries should be eliminated.

INTRODUCTION

The Staggers Rail Act of 1980 legalized contracts between rail carriers and shippers and set minimal requirements for the disclosure of contract terms for all commodities moved under contract. The legislation also set in motion a series of Interstate Commerce Commission (ICC) proceedings to establish operational procedures for contract filing and for contract approval. Significantly, the Act established more exacting disclosure requirements for certain agricultural commodities than for other commodities, as well as an expanded basis where affected agricultural shippers could challenge contract legitimacy. The Conrail Privatization Act (Pub. L. 99-509) subsequently clarified the information requirements applying to grain contract disclosure and directed the ICC to provide more "liberal" discovery to grain shippers who seek remedies from "discriminatory contracts" than the Commission had previously allowed. During the period 1980 to 1986, the ICC issued several sets of rules affecting contract disclosure. In March 1988, the Commission issued a set of final rules that complied with the Conrail Act. These rules stand today.

More than ten years have passed since the passage of the Staggers Rail Act. A reasonable time for reflection has likewise passed since the ICC implemented its final rules concerning contract disclosure. During the intervening period, grain markets have adapted, both to the new contracting freedoms, which rail carriers have exercised since 1980, and to the regulatory framework which still constrains these freedoms -- a framework that has been in place since 1986. The time is now appropriate to evaluate the effects of deregulation and of contract disclosure. This study is intended to provide a mid-course review and analysis of rail commercial practices that have evolved in one specific rail market -- the market for whole grains. This is the only market where Congress established more restrictive rules for contract disclosure. In a sense, it is a public policy audit of post-Staggers Act performance within one unique, albeit important, segment of the total rail market. It is also a case study of the market impacts and consequences resulting when a formerly highly regulated set of rail marketing activities are allowed to operate with minimum regulatory oversight.

Contract disclosure was originally intended as a mechanism to assure the efficient operation of grain transportation markets and to further assure that the interests of small grain shippers were balanced against the economic forces that deregulation had released -- forces that quickly drove rail grain contracting toward low cost/volume leveraged formats, after deregulation.

The supporters of grain contract disclosure believed that markets operate more efficiently when buyers and sellers have complete and timely information on the activities of all participants in the market. As information about price, contract terms, and services offered becomes more accessible to market participants, the operation of the underlying market itself becomes more efficient. Pervasive information has a centripetal force on contract terms. It tends to pull terms to the center of a normal distribution and to reduce the ability of sellers to differentiate services among diverse buyer groups.

The following study tests the theory underlying contract disclosure against the recent historical experience of rail carriers and shippers who have conducted business in the post-Staggers environment.

1.0 BACKGROUND ON CONTRACT DISCLOSURE REQUIREMENTS

This chapter is intended to provide background information on contract disclosure rules, their interpretation by the Interstate Commerce Commission, their regulatory evolution, and their current status. This chapter also provides a timeline for the implementation of contract disclosure rules and a framework for interpreting the market response of individual railroads to disclosure. The chapter underscores the fact that contract disclosure has been, from its legislated inception, highly controversial and subject to intense debate with regard to its interpretation. Indeed, Congress returned to the issue of grain contract disclosure six years after it originally mandated disclosure in the Staggers Act, to provide its own legislated interpretation of disclosure requirements in the Conrail Privatization Act of 1986. The background information that follows is intended to inform and clarify subsequent chapters. Those chapters deal with the impact and consequences of contract disclosure in the marketplace.

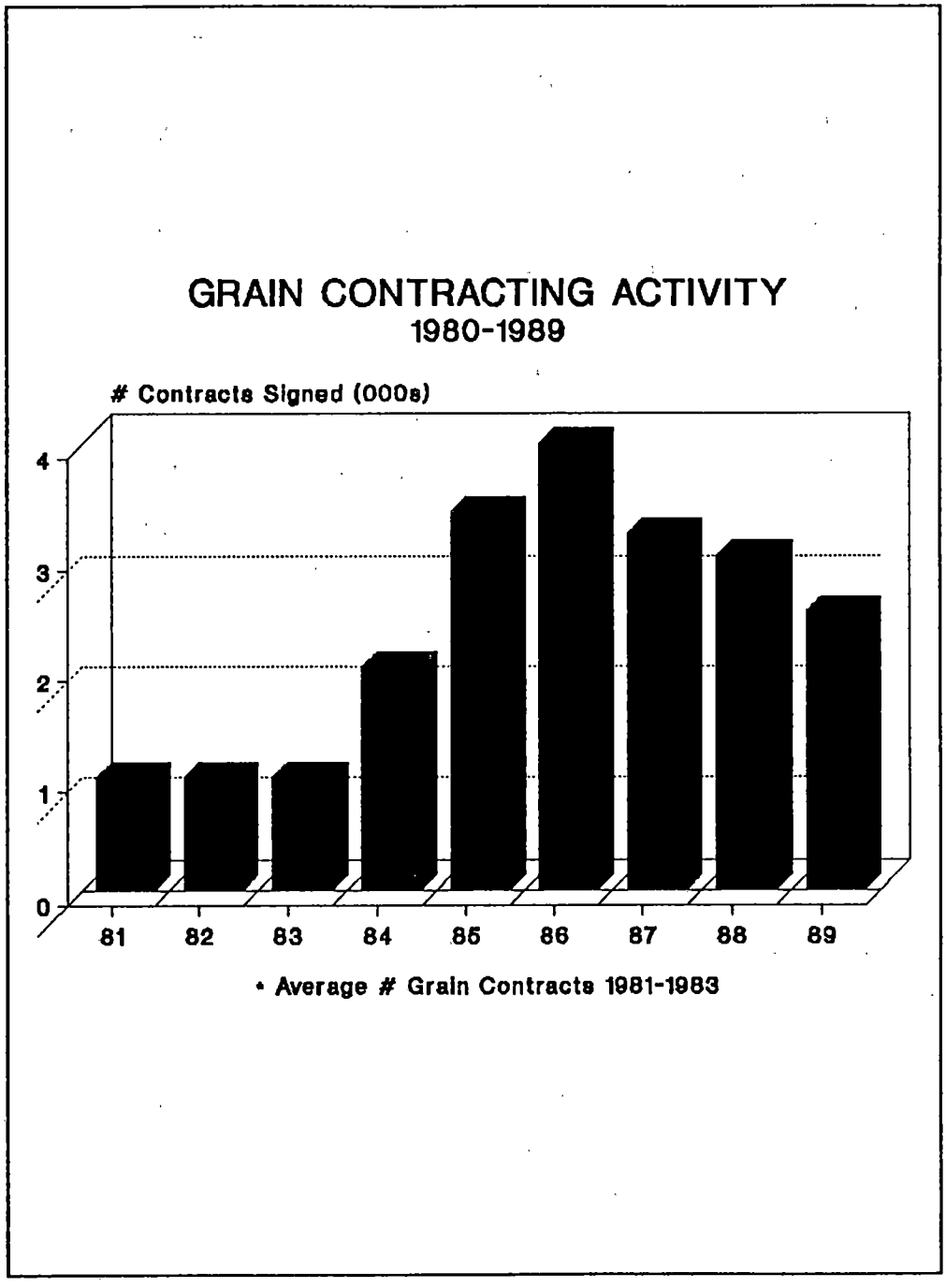
1.1 THE STAGGERS ACT AND THE EMERGENCE OF GRAIN CONTRACTING

The principal impetus to railroad contracting came in 1980 with the passage of the Staggers Rail Act ("Act"). Although the Interstate Commerce Commission (ICC) had permitted railroads to contract since the late 1970's, it was not until the passage of the Staggers Act that contracts were explicitly legalized and that railroads began developing commercial programs based to a significant degree on contract commitments.

As Figure 1.1 demonstrates, rail contracting activity in grain markets began to increase gradually in 1981, 1982 and 1983 from a minimum base, as a direct result of the Staggers Act. Grain contracting activity increased markedly in 1984 and even more rapidly in 1985 and 1986. Contracting activity peaked in 1986 and then fell off in subsequent years from the 1986 high water mark.

The Staggers Act clearly triggered rail contracting activity in the 1980's. Section 208 of the Act clarified, for the first time, the conditions under which rail carriers and purchasers of rail service could enter into contracts. Key

Figure 1.1



Source: ICC Grain Contract Summaries

provisions of Section 208 include the following: 1) All contracts must be filed with the ICC, along with a summary of non-confidential information describing contract provisions. 2) Essential contract terms must be presented in a tariff format. 3) With regard to challenges to contracts, the Act determines that the Commission can initiate a proceeding to review a contract either on its own initiative or in response to a complaint filed either by **a shipper** or **a port**. 4) Shipper challenge can be based on the claim that a shipper is individually harmed by the contract or that the contract would unduly impair the rail carrier's ability to provide common carrier service to the shipper. 5) A port can challenge a contract on the grounds of "unreasonable discrimination," but not on grounds of impairment of common carrier service ability. 6) In the arena of agricultural commodities (including forest products and paper), the basis for contract challenge is more liberal. Agricultural shippers can challenge contracts on multiple grounds, including: a) "unreasonable discrimination," if the rail carrier refuses to offer similar terms to the complaining shipper; b) impairment of the rail carrier's ability to provide common carrier service to the shipper; and/or c) destructive competitive practice.

With regard to approval/disapproval of contracts, the Act determines that: 1) If the ICC does not initiate an investigation within 30 days after the contract is filed, the contract will stand approved. 2) If the ICC does not disapprove the contract within 60 days after it is filed, the contract is automatically approved.

The Staggers Act further mandated that the ICC must establish special rules, under which essential elements of contracts will be made available to the general public. The Act further requires that the quantity of equipment that can be utilized in contracts involving agricultural commodities shall be limited to 40% of the capacity of a railroad's owned or leased equipment fleet unless a waiver from the ICC is obtained. This 40% is to be determined by major car type. For larger agricultural shippers (those who originate 1000 or more cars), not more than 40% of the carrier-owned or leased equipment used by that shipper, on average, over the previous three years, can be used for a contract between that shipper and the railroad, without prior ICC approval.

1.2 CONGRESSIONAL INTENT REGARDING RAIL CONTRACTS

The Staggers Act of 1980 attempted to remedy many of the problems associated with the regulation of the railroads. It removed many of the constraints regulators had imposed on the rail industry and thereby enabled the industry to compete more effectively in the transportation market. At the same time Congress recognized that in some areas, where a railroad had a dominant market position, continued regulation was necessary to restrain potentially abusive actions by the railroad. In the Staggers Act, Congress attempted to balance a need to make the railroads more competitive and profitable with a need for continued regulation in areas where total deregulation could lead to abuse of market power.

The contract rate provision is one of the most important provisions of the Staggers Act. Congress felt that contracting offered potential benefits to both carriers and shippers.[1] Contracts gave the railroads "assured levels of revenues" and assured shippers of "specified levels of service, at known rates."[2] They allowed for better planning on the part of both shippers and carriers. The expectation existed that contracting would improve both car utilization and the allocation of equipment. Congress also expected that contracts would provide a higher degree of certainty, particularly in areas where large capital investments were required.

Confidential contracts were of great concern to small shippers - country grain elevator operators, grain brokers, farmers' coops - who believed they had little bargaining power in contract negotiations. They were concerned that confidential contracting would put them at a disadvantage vis-a-vis large shippers, who would be able to secure preferential rail contracts. Their concern was based on the fact that traditional "basis point" pricing structures for grain are closely tied to published rail tariff rates even if another form of

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[1] Report of the House Interstate and Foreign Commerce Committee on the Stagger Rail Act of 1980, Report No. 96-1035, May 16, 1980, p.57. The report stated that "The Committee believes that the contracts serve both shippers' and rail carriers' interests by reducing uncertainty about market and service conditions ... Contracts will permit the shipper and carriers to maintain long-term rate stability and assure quality service."

[2] Report of the Senate Committee on Commerce, Science, and Transportation on S. 1946, Railroad Transportation Policy Act of 1979, Report No. 96-470, p.24.

transportation is used. Grain is typically priced and hedged based on its delivered cost to a centrally located grain distribution center, such as Kansas City. The price of delivered grain is based on an aggregation of separate transportation, storage and farm value components. In the pre-Staggers era, country elevator operators could determine, as could everyone else in the grain distribution channel, when a bid price for grain was reasonable. All of the essential cost components that went into that bid price were known, including importantly, the commodity or flat price and the published rail transportation rate. From these, the country elevator operator could calculate the competitive price for farmers in his region and determine the competitiveness of wholesale prices that grain merchandisers were offering. Opponents believed that confidential contracts would change this situation and inject more uncertainty and more risk into the distribution channel. Most of this risk would shift to the small volume grain shippers who typically would not hold contracts with rail carriers and who would not have certain information concerning confidential contract terms.

Congress shared this concern. In order to protect the small shipper, Congress retained the common carrier obligation of railroads in the Staggers Act. This obligation would prevent railroads from serving only their most profitable customers. Congress feared that relief from common carrier obligations could result in the burden of poor service and higher rates falling disproportionately on small shippers who are typically not contract holders. With this concern in mind, Congress imposed the 40% limitation on the amount of equipment that could be dedicated to contract service. Congress also imposed this limitation on large shippers to protect the ability of the small shipper to obtain sufficient cars. Congress established that the remainder of large shipper car needs, above 40%, would be supplied under common carrier obligations -- the same basis under which other non-contracting shippers would be supplied. Small shippers, on the other hand, who originate fewer than 1,000 cars per year, could contract for 100 percent of their needs.[3] The

[3] Report of the Committee on Conference on S.1946, Staggers Rail Act of 1980, Report No. 96-1430, September 29, 1980, p.99.

equipment limitation provisions applied only to agricultural commodities, and forest and paper products because these were markets where carriers had experienced problems in providing equipment.

Congress also defined the basis on which affected shippers could seek relief to injuries caused when contract commitments precluded carriers from fulfilling their common carrier obligations. For agricultural commodities, including forest products and paper, however, Congress established a more liberal basis for relief as discussed in Section 1.1 (page 5). These more liberal standards were again intended to protect the rights of small shippers. In agricultural commodity markets, contracts were subject to unique anti-discrimination and destructive competitive practices tests. To further protect the small shippers of all commodities, including grain, Congress required that contract summaries be made available to the public at large. Both contract summaries and actual contracts were to be filed with the Commission. The summaries were expected to contain enough information to allow a shipper to ascertain if possible grounds existed for seeking relief.

To insure that smaller shippers and other interested parties were informed of the relevant provisions of contracts, as they were filed and acted upon by the Commission, Congress intended that a contract rate advisory service would be set up, which would compile and disseminate summaries of nonconfidential contract information. Thus, Congress attempted to balance the interests of small shippers with those of large shippers and the railroads.

1.3 COMMISSION'S INTERPRETATION AND IMPLEMENTATION OF SECTION 208 OF THE STAGGERS ACT

The Commission issued interim rules in 1980, and final rules in 1982 to implement the contract and disclosure provisions of the Staggers Act. The ICC interpreted the Staggers Act provisions relating to disclosure to mean that contract summaries (first-tier disclosure), but not the contracts themselves, must be made available to the public. In order to gain access to the terms of the actual contract (second-tier disclosure), the ICC required a complainant to demonstrate: 1) that the complainant is likely to succeed on the merits of his or her complaint; or 2) that the matter complained of could not be proven

without access to the complete contract.

The ICC required the following information to be disclosed in contract summaries: 1) names of railroads involved; 2) commodities involved; 3) duration of contract; 4) number of railroad cars (owned or leased), by major car type, utilized in the contract; 5) base rate; and 6) existence of (but not the terms of) special features in the contract. In addition, for agricultural commodities (including forest products and paper), the ICC required the 1) identification of origin and destination stations for all movements included in the contract; 2) movement type (e.g., single car, multiple car, unit train) and 3) minimum annual volume. The Commission also prescribed additional car availability data to be included in the summaries.

These rules continued to be a subject of intense debate and disagreement between agricultural shippers and the railroads. A court challenge (Water Transport Association v.ICC, 722F. 2d 1025, 2d cir. 1983) found that the Commission's rules on second-tier disclosure were too restrictive. In response to the Court order, the ICC modified the conditions for second-tier disclosure and issued interim rules in 1984.

The debate on contract disclosure for agricultural commodities, however, continued. In 1986 the Association of American Railroads (AAR) and the National Grain and Feed Association (NGFA) agreed to a set of rules on first and second-tier disclosure. The ICC endorsed this compromise and adopted it, in principle, as the basis for proposed rules in April, 1986.

1.4 THE CONRAIL PRIVATIZATION ACT

Before these revised rules could be finalized, however, Congress intervened with the Conrail Privatization Act. During the oversight hearings on the Staggers Rail Act of 1980, senators and congressmen from agricultural states expressed concern about the impact of contracts on small agricultural shippers. Although the shipping public broadly accepted that contracts would enable them to obtain substantial rate discounts, to pursue innovative distribution strategies and to resolve service problems with carriers, these

benefits were not shared equally by all shippers, especially not with small shippers who were unable to secure contracts readily. The shift from tariff-based rail rates to contract rates was particularly dramatic for small shippers, who previously functioned in a market environment based on the "visibility" of rail rates available to large and small shippers alike. In hearings leading up to the Conrail Act, much attention was directed to the differential in bid prices paid to country elevators by purchasers who had transportation contracts versus those who did not. Apparently, it was the intent of Congress, in the Conrail Act, to liberalize contract disclosure rules so that small shippers would be protected in a service environment newly dominated by contracts. Thus, Congress mandated that additional information must be disclosed in contract summaries for agricultural commodities.

In the Conrail Privatization Act, Congress redefined first-tier disclosure requirements. Whereas the Staggers Act had directed that "a summary of the contract containing such nonconfidential information as the Commission prescribes" shall be filed with the ICC, the Conrail Act identified specific information that must be filed with the ICC in grain contract summaries.

It added several new requirements to those already prescribed by the ICC for first-tier disclosure, including the following: 1) shipper identity; 2) transit points; 3) contract duration and optional extension; 4) actual volume information; and 5) other shipper facilities requirements. The Act also directed the ICC to provide liberal discovery to shippers seeking remedies under this section. Congress also directed that any amendment, supplement, or change to any of the items listed above, including extensions of a contract, should be treated as a new contract for filing purposes.

1.5 COMMISSION'S INTERPRETATION AND IMPLEMENTATION OF THE CONRAIL PRIVATIZATION ACT

The Commission issued interim rules on December 15, 1986 and final rules, effective March 25, 1988 to implement the changes legislated by

Congress in the Conrail Privatization Act. The ICC also incorporated into the rules changes mandated by the 2nd Circuit Court in Water Transport Ass'n v. ICC, 722 F.2d (2s Cir. 1983) and features of the AAR/NGFA compromise proposal, referred to above. Some of the key provisions of the final rules, relating to agricultural commodities, include the following:

Definition of the terms "contract" and "amendment." An amendment to an existing contract is deemed to be a separate and new contract, and consequently all remedies against the contract are revived. The entire review is available from the date when an amendment is filed. All contract amendments, supplements, or changes are treated as new contracts, which require the filing of new and complete contract summaries. Although the ICC agreed with the NGFA and AAR that the scope of review of amended contracts should be more limited than the original review, it did not attempt to define the scope of a more narrow review in the final rules.[4]

Time limits for filing. The ICC declined to adopt any specific time limit for contract filing. It also permitted the retroactive filing of contracts without a specific time limit, since it felt that the benefits this allowed, in terms of flexibility, outweighed the potential for abuse. The ICC felt that adequate incentives existed on both the carrier side and the shipper side, in the form of benefits provided by an approved contract, to prompt expeditious filing. The Commission believed that carriers would file promptly in their own interests, and shippers would likewise pressure carriers to file promptly.

Shipments moving under contract amendment. In its final rules, the ICC reversed a prior decision that contract amendments fall outside its jurisdiction. The Commission had previously reasoned that a contract, once approved, is not subject to the relevant portions of the Interstate Commerce Act. In its final rules, the ICC determined that, in light of direction given in the Conrail Act, that

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[4] 4 I.C.C.2d, p.230.

it had the same jurisdiction over amendments as it had over new contracts. Consequently, the same set of rules apply to movements covered by contract amendment as apply to movements covered by new contracts.

Specific commodities. The ICC decided to continue the requirement that specific commodities be listed in the contract and contract summaries. Small shippers supported this rule. Larger shippers generally opposed it. Both AAR and NGFA had, in particular, suggested broader categorization (such as the term "grain"), or the use of the same commodity description in the contract and the summary. The ICC rejected this position.

Shipper identity. Since grain can be sold several times between the date of the contract and the date of the actual movement, it is difficult to identify the name of the party obligated under the contract until after a movement is complete. The ICC limited the identification of contracting parties to those known at the time the contract is entered into.

Specific origins and destinations. The ICC allowed the use of tariff references for origin/destination information. If tariff references were used in the contract, the ICC required that the summary must identify the states where the origins/destinations are located in addition to the tariff reference.

Shipper facilities. The Conrail Act mandated that shipper facilities be shown on the contract summary. The ICC interpreted this to mean disclosure of those locations (that satisfied the volume requirements of the contract) as best known at the time of contracting, or as identified in the contract itself.

Contract duration. The final rules required the contract effective date, contract termination date, and the application date for shipments moved prior to the effective date.

Base rates and charges. The rules required identification of base rates or charges, or identification of the specific tariff provisions that would apply. This information is required in lieu of actual rates and charges.

Volume requirements. AAR and NGFA successfully argued that failure of Congress to include "volume requirements" in the Conrail Bill implied acceptance by Congress of prior rules that included "volume requirements" in the "special features" provision of the summary. The "special features" provision required the reporting of the existence of any special contract provisions, but not specific terms or amounts. The ICC agreed and adopted this interpretation in its final rules.

Informal discovery. A potential complainant often needs additional information from a railroad to determine whether or not he has a basis for filing a formal complaint with the ICC. The process whereby a shipper requests and receives such information from a railroad is referred to as informal discovery. The final rules addressed several issues involving informal discovery. To avoid conflict with the Sherman Act, which prohibits agreements among firms to exchange price information, the ICC restricted the use of material disclosed in the informal discovery to that required for full regulatory review. The final rules stated that: 1) A petitioner ("affected party") ***may*** request discovery from the carrier; 2) A carrier ***must*** promptly grant or deny the request; 3) Informal discovery is not a prerequisite to secondary disclosure.

Affected Party. In light of the Congressional mandate in the Conrail Bill and the Second Circuit Court decision, the Commission's original test for "affected party" was deemed too restrictive. In its final rules, the ICC dropped the requirement that an affected party must: 1) establish that it will be harmed by the contract; and 2) show how the contract could actually or potentially cause injury. Instead, the ICC defined an "affected party" as one which is an actual or potential participant in the relevant market. It eliminated the injury requirement from its test. Basically, a petitioning shipper, under the final rules,

was required to show that it was ready, willing, and able to participate in those terms of the contract that it knew about through first-tier disclosure.[5] The ICC required the following information to make this determination: 1) nature and size of petitioner's business; 2) relevant commodities shipped/received; 3) comparison of commodities, traffic patterns, and serving carriers for the petitioner, with those identified in the contract summary; 4) ability to ship at a time generally simultaneous with the contract at issue; and 5) other appropriate information.

Injury. In its final rules, the ICC eliminated the "injury" test, the "demonstrated need" criterion, and the "prior negotiation" requirement for contract discovery. This was in response both to the Conrail Act, that mandated more "liberal discovery" for agricultural commodities, and also to the Second Circuit Court decision. However, a large number of groups responding to the Commission's interim rules, including the AAR, NGFA, Kansas Grain and Feed Dealers Association, U.S. Department of Transportation, the American Food Industry Association, etc., supported some sort of injury showing for contract discovery. The NGFA argued, and the ICC agreed, that "liberal discovery" applied to the extent of discovery when granted, not to whom granted. The ICC, however, decided not to use the term "injury," because of its connotation of specific and identifiable harm. Instead, in the final rules, the ICC added a requirement that a petitioner requesting discovery show how it could be "affected," either actually or potentially, by the contract terms.

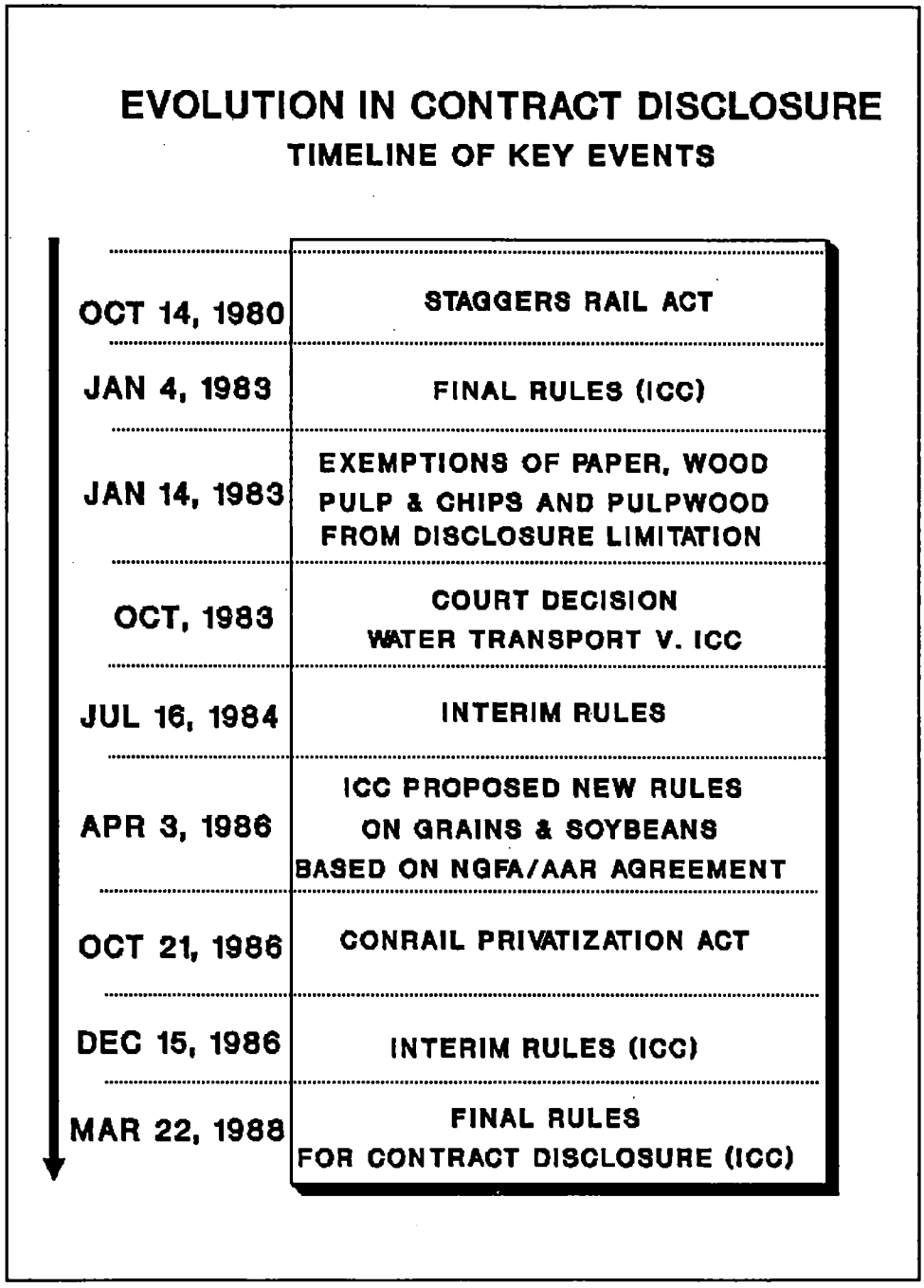
1.6 CONTRACT DISCLOSURE TIMELINE

As the discussion above reveals, the interpretation and implementation of disclosure requirements required much more time than either the Congressional authors of the Staggers Act or the carrier/shipper community originally anticipated. The time line in Figure 1.2 marks key developments in the evolution of contract disclosure requirements. This information offers an

[5] 4 I.C.C.2d, p.258.

historical framework for tracking parallel developments in the commercial arena. A detailed discussion of key regulatory and legislative developments along the timeline can be found in Appendix A to this report.

Figure 1.2


EVOLUTION IN CONTRACT DISCLOSURE
TIMELINE OF KEY EVENTS
OCT 14, 1980
STAGGERS RAIL ACT
JAN 4, 1983
FINAL RULES (ICC)
JAN 14, 1983
EXEMPTIONS OF PAPER, WOOD PULP & CHIPS AND PULPWOOD FROM DISCLOSURE LIMITATION
OCT, 1983
COURT DECISION WATER TRANSPORT V. ICC
JUL 16, 1984
INTERIM RULES
APR 3, 1986
ICC PROPOSED NEW RULES ON GRAINS & SOYBEANS BASED ON NGFA/AAR AGREEMENT
OCT 21, 1986
CONRAIL PRIVATIZATION ACT
DEC 15, 1986
INTERIM RULES (ICC)
MAR 22, 1988
FINAL RULES FOR CONTRACT DISCLOSURE (ICC)

2.0 COMPETITION AND CHANGE IN THE 1980'S GRAIN MARKET

Rail deregulation and the freedom to contract for grain services was introduced into a notably soft market -- a "buyer's market." Rail carriers began their experimentation with the new freedoms the Staggers Act allowed during an extended period of sharp retraction in U.S. grain export activity and a period of relatively slow growth in domestic consumption. During this time, volatility increased measurably in world grain prices as more grain production came into the world market and as U.S. farm policy increasingly exposed U.S. producers directly to foreign price competition. Also during this period, federal farm subsidy and storage programs increasingly affected domestic grain markets. We will discuss these factors and others in the following chapter. External market conditions greatly influenced the commercial strategy development of individual carriers. Separating external market effects from the effects of regulatory reform is complex. Both factors clearly influenced the market strategy development of individual rail carriers in the 1980's. However, an argument could be made that the impact of contract disclosure would have been quite different in a "seller's" market.

An understanding of the grain markets, and factors (both domestic and external) that influence them, is critical to understanding the unique market served by each carrier.

2.1 SLOW GROWTH MARKET

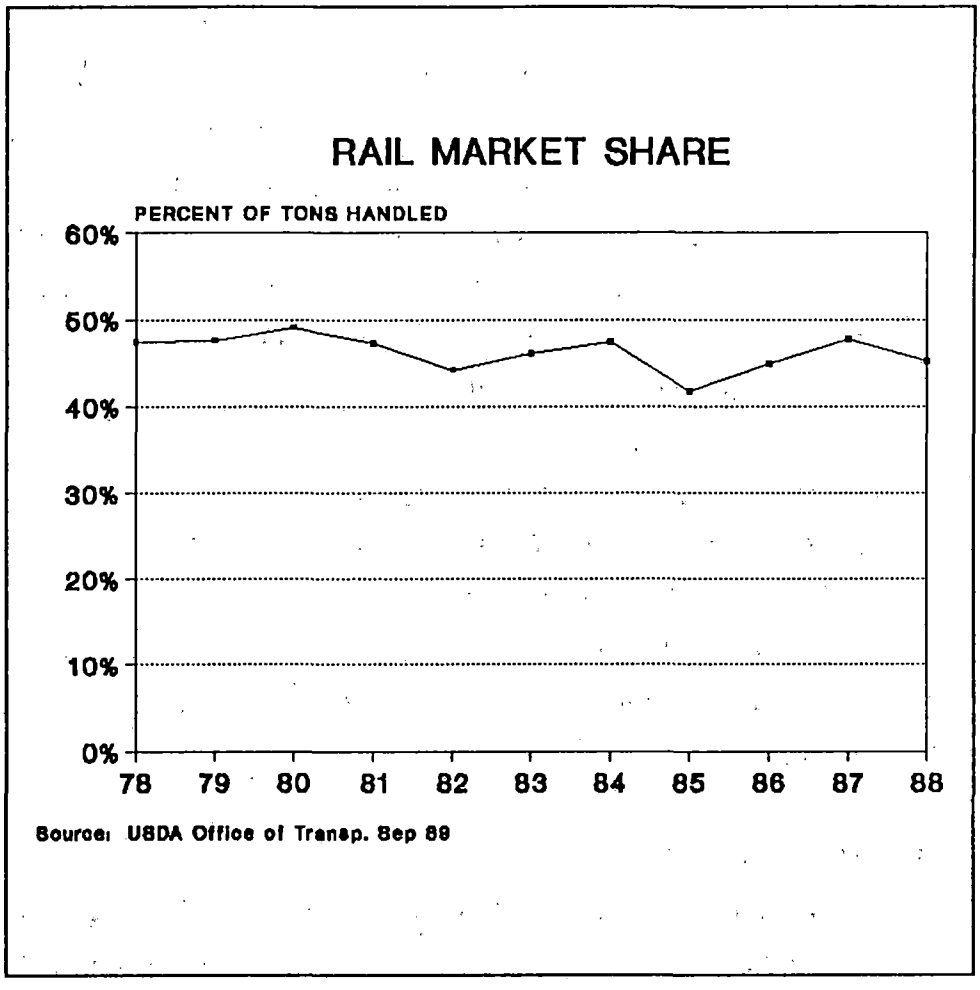
The grain transportation market in the United States grew at a rate of 3.5% per year during the 1980's.[6] However, this figure overstates growth for most of the period. Much of the increase in grain handling, from 244 million tons in 1978 to 348 million tons in 1988, occurred only at the end of the decade in 1987 and 1988 when both export and domestic markets spurted.

In spite of the new contracting freedom and active commercial experimentation, the rail share of the total grain market actually fell from 49.1% in 1980 to a low of 41.7% in 1985. Rail market share rose again in 1986 to

[6] Unpublished data furnished by USDA Office of Transportation.

45.2% and further in 1987 to 47.7% before falling off in 1988, as shown in Figure 2.1.[7] It appears that rail carriers have not fully succeeded in effecting fundamental modal share shifts in the grain distribution system, in spite of energetic efforts since the passage of the Staggers Act.

Figure 2.1



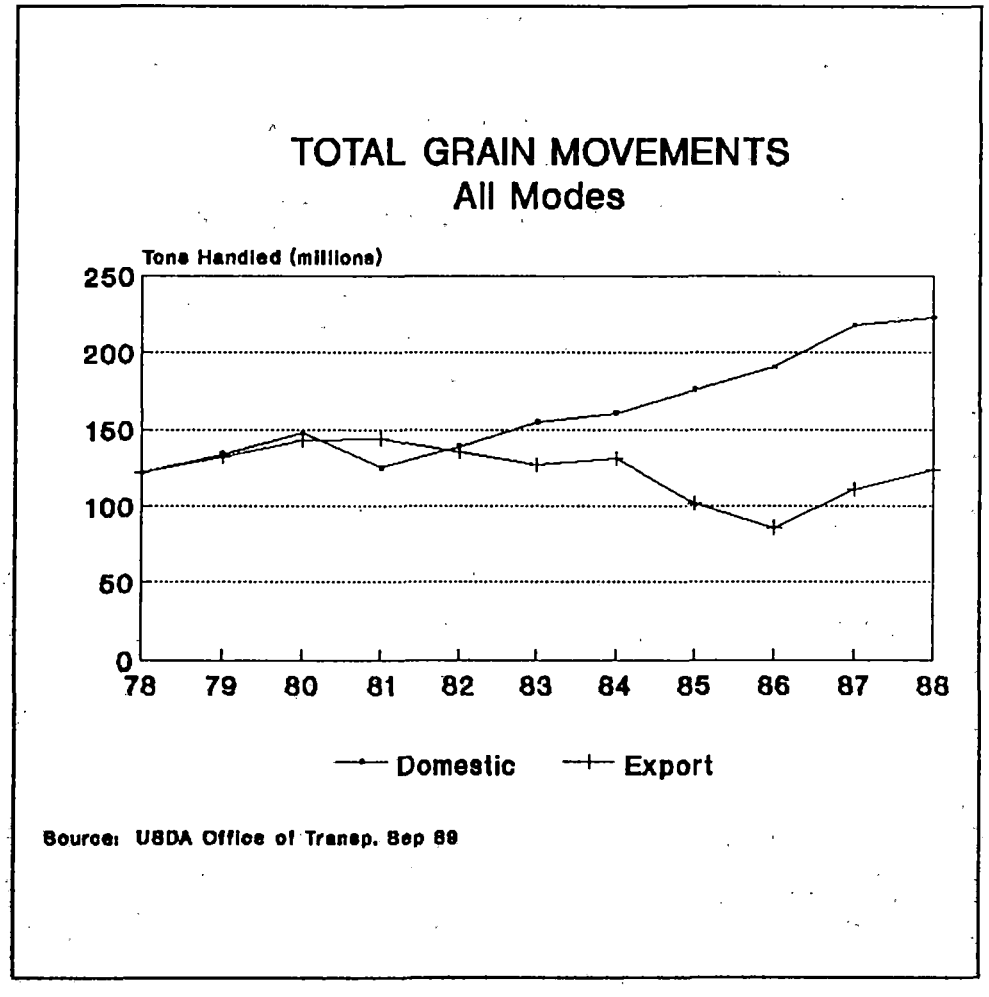
Grain markets are made up of two principal components -- domestic consumption and export grain. During the past decade, domestic consumption increased steadily from 122 million tons in 1978 to 224 million tons in 1988. [8]

[7] Rail market share figures are based on tons handled. Unpublished data furnished by USDA Office of Transportation.

[8] Unpublished data furnished by USDA Office of Transportation.

Indeed, only the recession years, 1981 and 1982, failed to realize positive gains in domestic consumption. During the same period, export grain volumes ebbed and surged from a high of 144 million tons in 1981 to a low of 87 million tons in 1986. During most of the decade, exports fell progressively, year after year. Only in 1987 and 1988 did export grain activity in the U.S. revive to levels comparable to levels at the beginning of the decade. Figure 2.2 illustrates these trends.

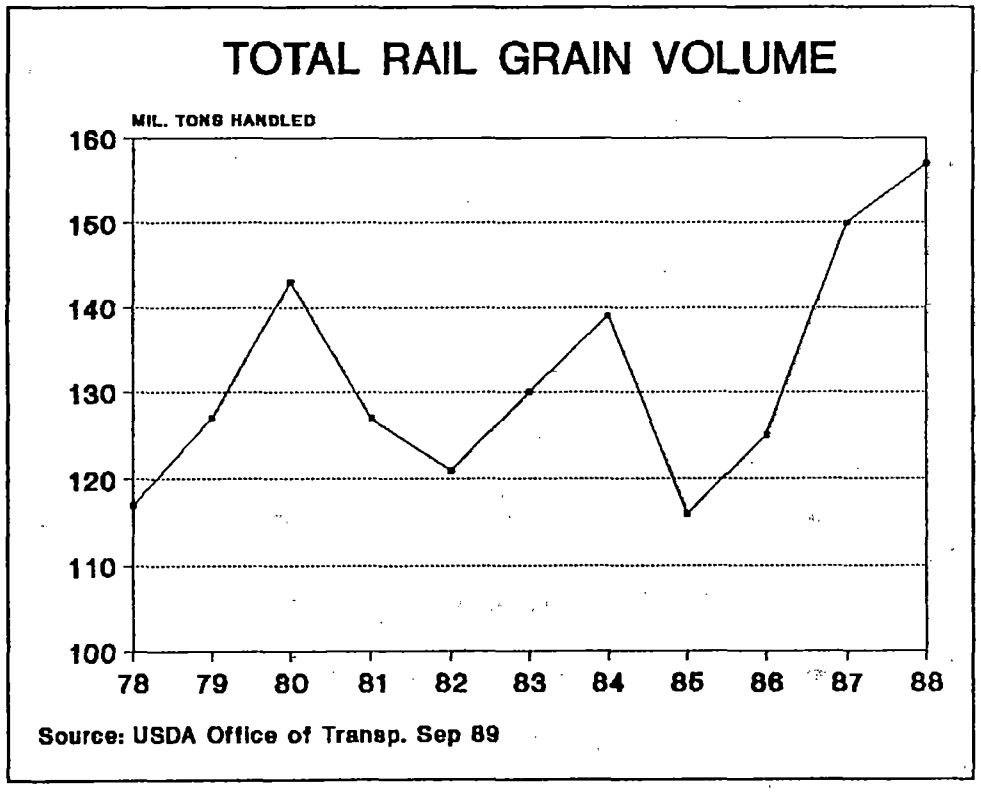
Figure 2.2



During the 1980's, demand for rail grain service increased by 34% from 117 million tons in 1978 to 157 million tons in 1988 (Figure 2.3). Most of this growth came only at the end of the decade. In spite of a strong market in

1987 and 1988, supply/demand capacity imbalances persisted during most of the decade. Indeed, railcar capacity exceeded demand until 1987 and 1988, after which the demand and supply appear to have become more balanced. The price of short term leases for rail covered hopper cars is one good surrogate measure of supply tightness. Rail grain marketers whom we interviewed revealed that covered hopper car lease rates remained at historically low levels during most of the 1980's, reflecting the prevailing excess capacity situation. Only in 1987 and 1988 were private covered hopper car owners able to command higher rents for their equipment. Moreover, rail carriers themselves added only limited capacity to their covered hopper car fleets during the 1980's.

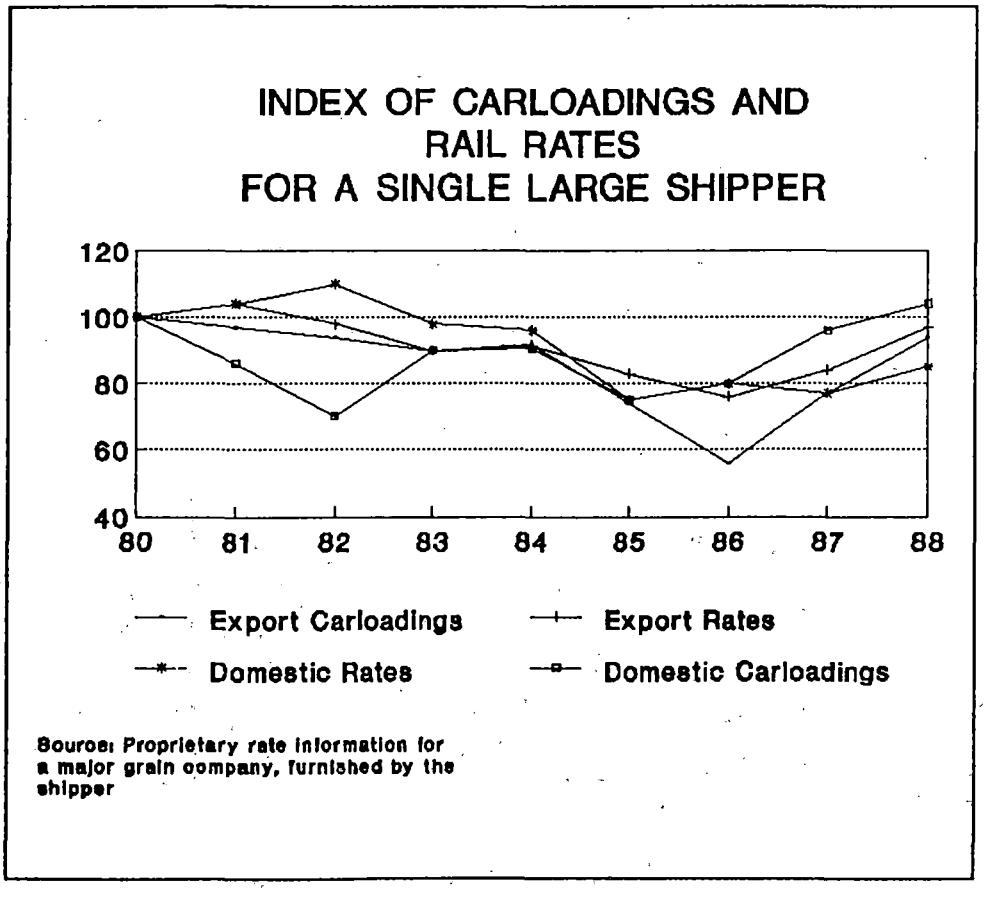
Figure 2.3



For most of the decade, downward market pressure continued to depress rail rates. Figure 2.4 reflects the experience of one of the nation's largest grain merchandising firms. Because of the size and diversity of this firm,

its experience in purchasing rail services is representative of the overall market. Note that domestic and export rates, measured in nominal terms, generally tracked downward with traffic levels during the 1980's. Likewise, rates for export traffic fell by 25% from 1980 through 1986. Rates for domestic traffic fell by 25% between 1980 and 1985. Export rates rose sharply from historically depressed levels only in 1987 and 1988, but still did not regain price levels which existed in 1980. Domestic rates similarly rebounded in these two years, although they only managed to reach levels well below those that prevailed in 1980.

Figure 2.4

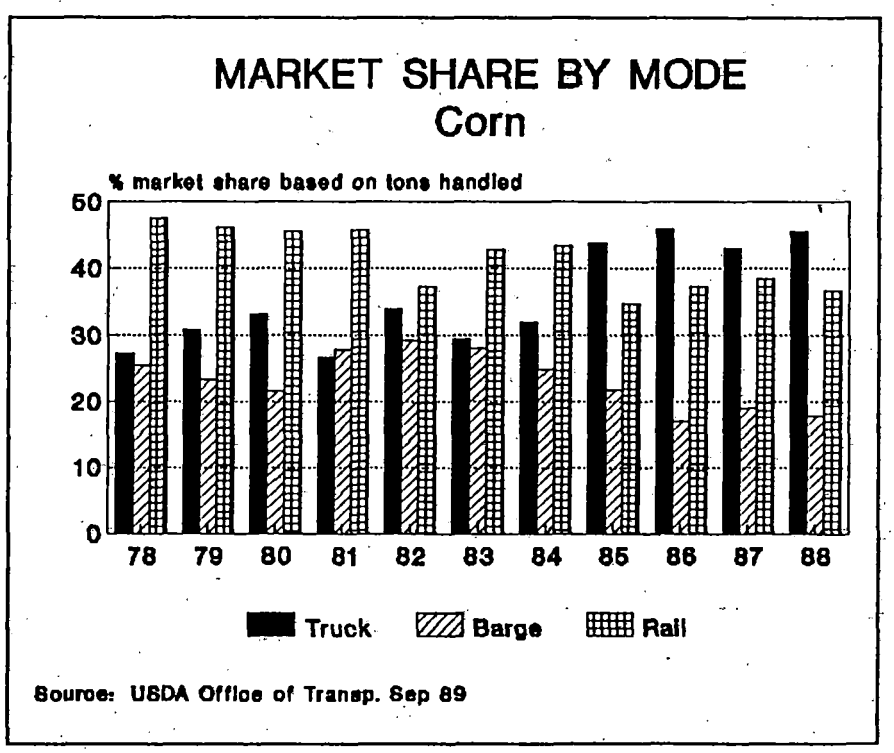


The decade-long trends observed at the aggregate level -- across grain markets -- cloaks the even more intense competition that existed among modes and carriers within specific grain markets. This competition underlies the development of specific market strategies developed by individual rail carriers. The following discussion reviews the external and environmental factors, which affected demand for grain transportation services, in each of the largest grain market segments: 1) corn, 2) wheat, and 3) soybeans.

2.2 FUNDAMENTALS IN THE CORN MARKET

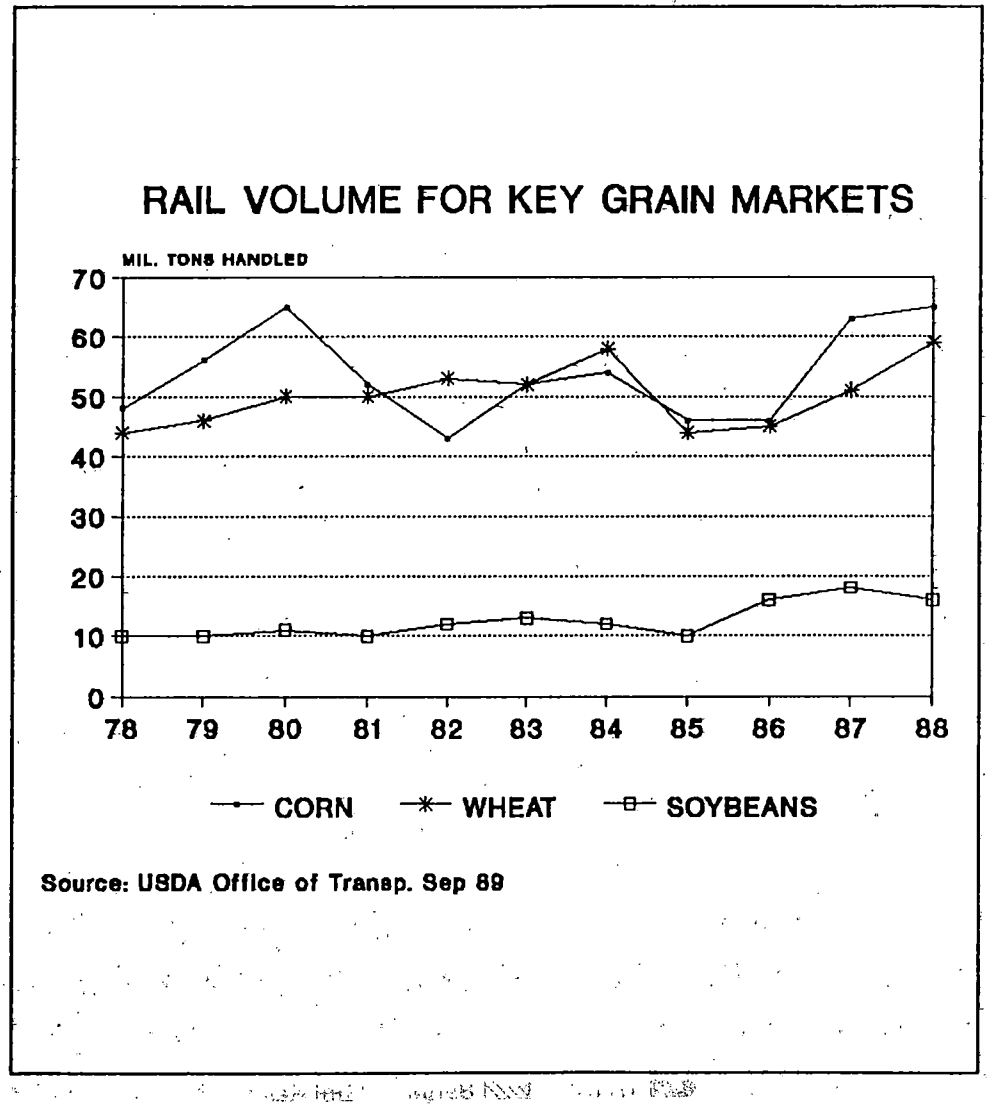
Among all grain markets, rail share has declined most markedly in corn markets during the 1980's, as illustrated in Figure 2.5. Rail share, measured in terms of tons handled, has declined from 47.4% in 1978 to 36.6% in 1988. During the same period, barge market share declined marginally, while truck direct share rose sharply. This shift suggests that fundamental logistics changes have taken place within this market and that corn processing facilities have moved closer to essential grain supplies.

Figure 2.5



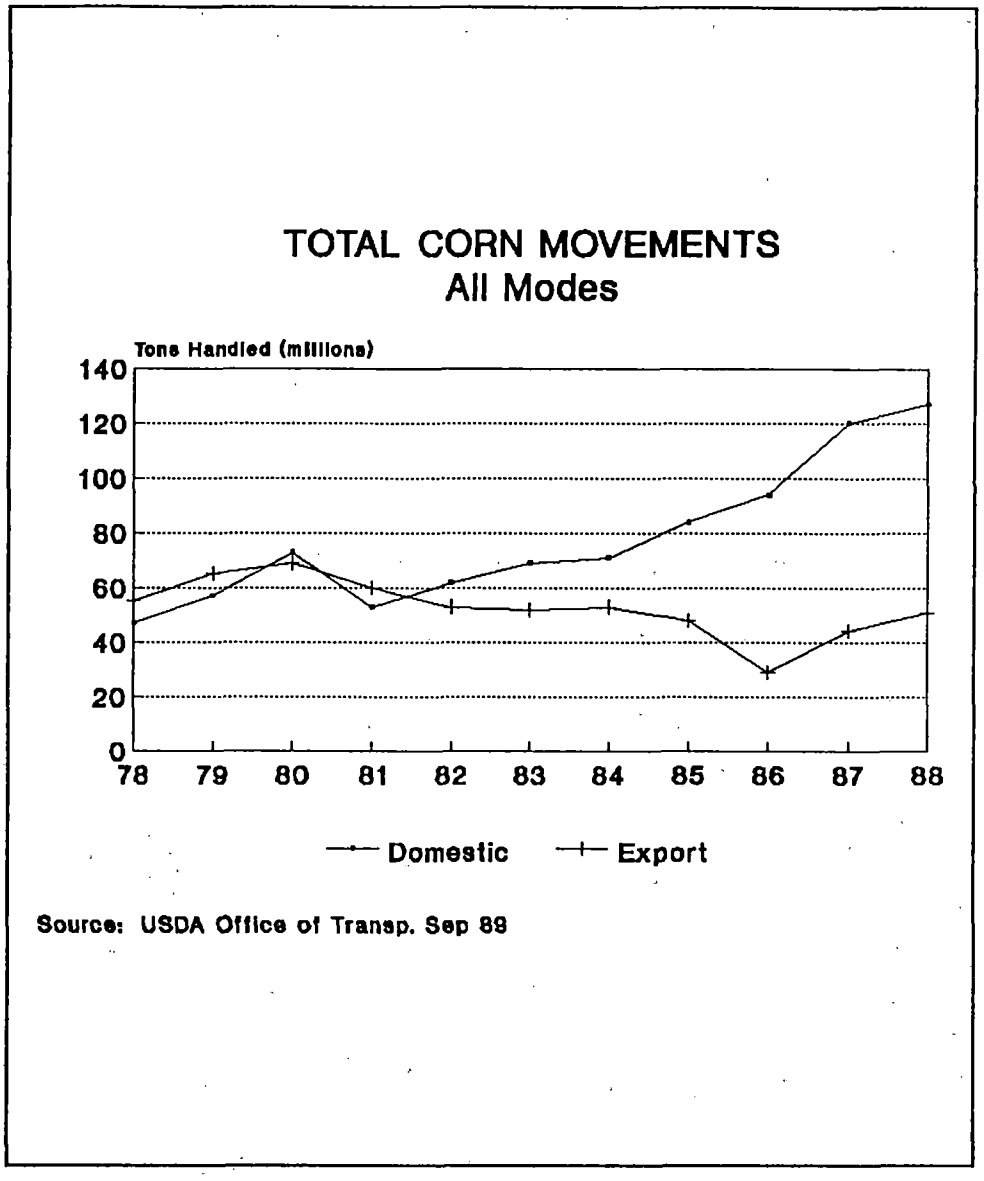
Overall, the corn transportation market has grown by 75% as measured by total tons shipped during the ten year period (1979-1988). Thus, even with a declining share, rails have increased their participation in this market from 48 million tons in 1978 to 66 million tons in 1988 (Figure 2.6). Domestic consumption accounts for all of the rail tonnage growth. U.S. corn exports actually declined during the ten year period, from 55 million tons in 1978 to 51 million tons in 1988 (Figure 2.7).

Figure 2.6



Source: USDA Office of Transp. Sep 89

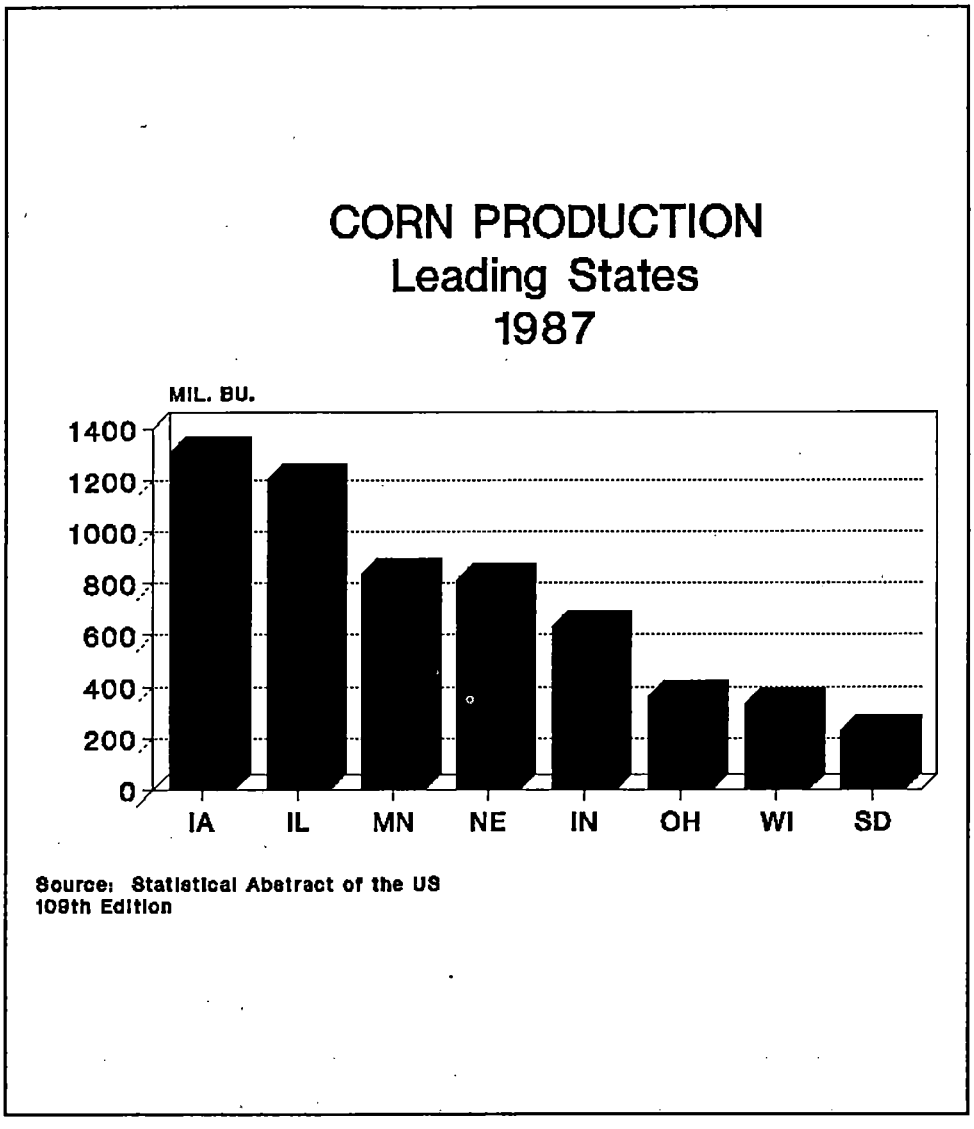
Figure 2.7



Corn is the leading U.S. farm crop in terms of both value and volume. Figure 2.8 illustrates the principal corn producing areas. Corn is principally used for livestock and poultry feeding and accounts for 79% of total grain fed to livestock. Approximately one-third of U.S. corn production is currently fed to livestock and poultry on the farms where it is grown. The remainder enters the national marketing system. The largest share of transported corn moves in an unprocessed form to feed livestock. The processed feed manufacturing

industry is the second largest user of corn. Corn sales to feed processors accounts for fully one-fourth of total use.

Figure 2.8



Food and food processing uses of corn represent a small but still significant proportion of total use. Food consumption, together with seed and industrial uses, accounts for approximately 20% of total domestic consumption. Principally as a result of expanding markets for corn sweeteners, the food processing market grew at a steady pace during the 1980's. Ethanol, made from corn, represents another expanding domestic use.

In the 1980's, the U.S. exported corn principally to Japan, the U.S.S.R., Mexico, Taiwan, Egypt, and South Korea. The volume of corn exported to the European Community declined sharply over the decade, from a relatively high level at the beginning. This fall-off was a direct result of EC farm support policies.

U.S. corn production fluctuated during the 1980's principally as a result of weather and federal support policies.[9] Farm production, however, had only an indirect effect on distribution activity. For example, in 1983 a combination of drought, the USSR grain embargo and the government's payment-in-kind program reduced corn production to 4.2 billion bushels. This was half the 1982 production level and the smallest corn harvest since 1970.[10] This precipitous production fall off, however, had only limited impact on grain movements. Because corn inventories were at record high levels at the beginning of 1983, after bumper crops in 1981 and 1982, traffic levels in 1983 significantly exceeded those in 1982. A second sharp reduction in production occurred in 1988, when drought reduced corn production by more than 30 percent from the previous year. But, again corn moved in relatively high volumes in 1988.

The 1980's have been an extremely volatile period for U.S. corn exports. Large swings occurred during this period both in world commodity prices and in exchange rates. During the 1980's, several new competitors emerged to challenge U.S. dominance in the world market, supported by national grain export programs. These new market entrants include Argentina, Thailand, South Africa, and China. These factors resulted in highly variable foreign demand for U.S. production. Federal stocks increased sharply in 1986 and 1987 as the government attempted to stabilize the competitive position of U.S producers vis-a-vis global competitors. Active federal intervention in world markets, however, only added another set of complicating variables to projected estimates of demand for rail carriage.

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[9] Hoffman, Linwood, Mark Ash, William Lin, Stephanie Mercier. U.S. Feed Grains: Background for 1990 Farm Legislation. A1B-604, U.S. Department of Agriculture, Economic Research Service, May 1990, p.5.

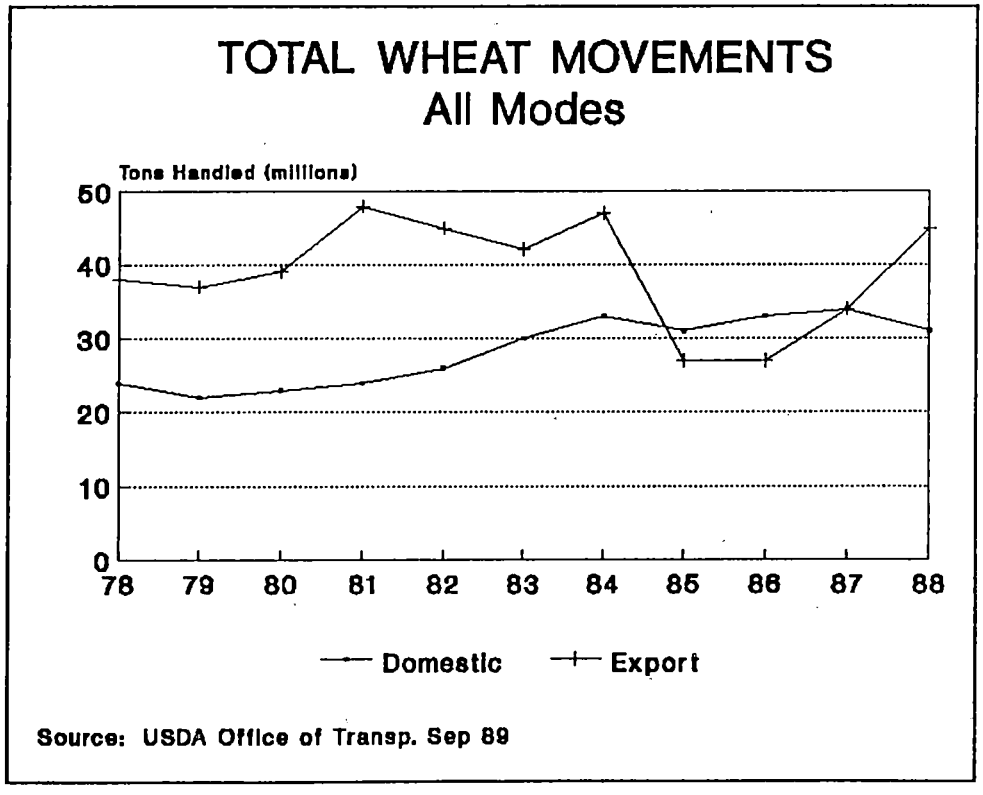
[10] Ibid

2.3 FUNDAMENTALS IN THE WHEAT MARKET

The wheat market was even more flat than the corn market in the 1980's. Wheat traffic increased only 23% between 1978 and 1988, and most of this increase occurred in 1987 and 1988.

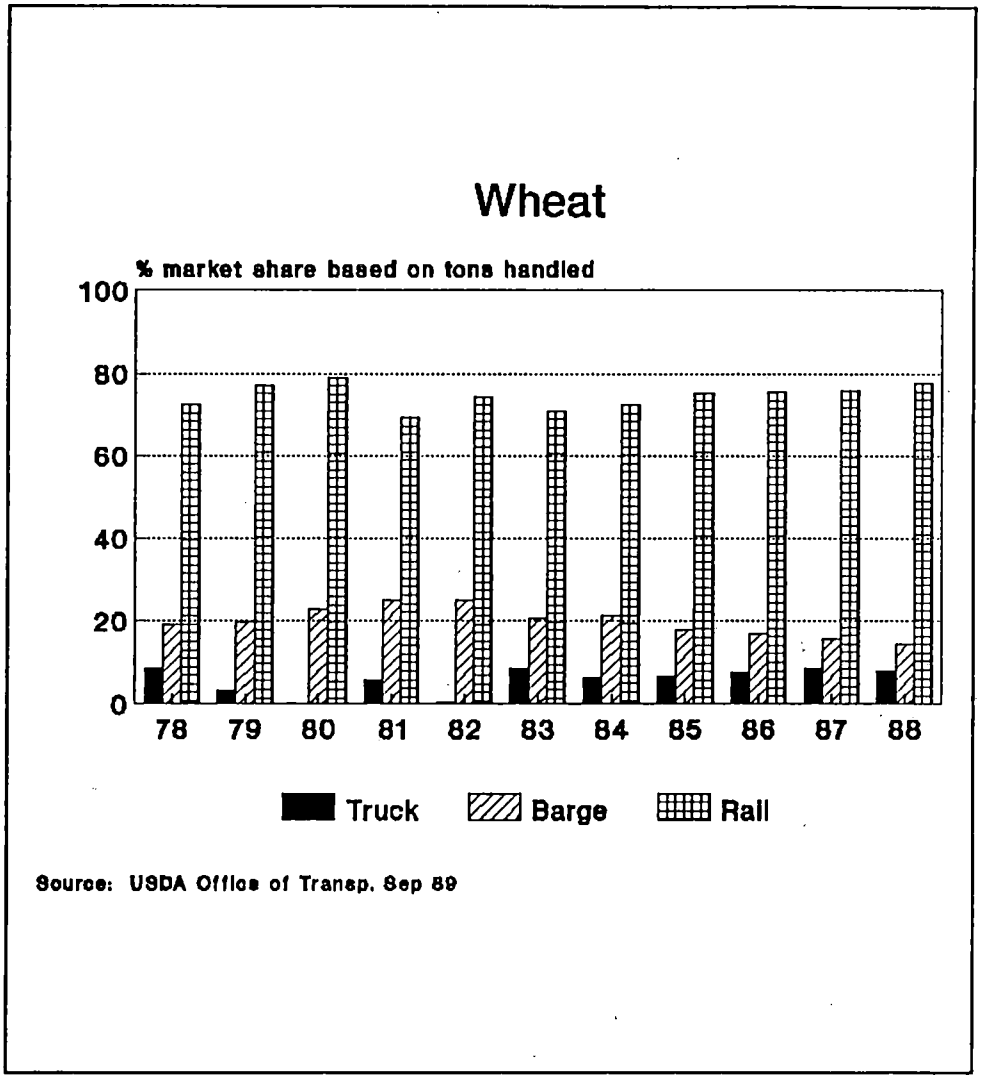
Wheat is the principal food grain produced in the United States. It is also the nation's principal farm export. Typically, wheat exports exceed domestic use levels. However, this relationship was reversed in the mid-1980's. Domestic wheat consumption grew slowly and steadily during the decade. In fact, domestic consumption grew every year until 1988 when volume fell off slightly. Export volume, on the other hand, declined for most of the decade. Export volume began at a 1981 peak and fell off sharply from this peak level. The years 1985 and 1986 represented low water marks for U.S. wheat exports. Export activity in 1988 only began to approach levels reached in 1983. These trends are illustrated in Figure 2.9.

Figure 2.9



Rail's share of this market increased marginally from 72.3% in 1978 to 77.7% in 1988, as shown in Figure 2.10. Over the same period barge share declined marginally and truck direct share increased, albeit, from a low base level. Overall, rail volume increased by 33% during the decade from 44 million tons in 1978 to 58 million tons in 1988.

Figure 2.10

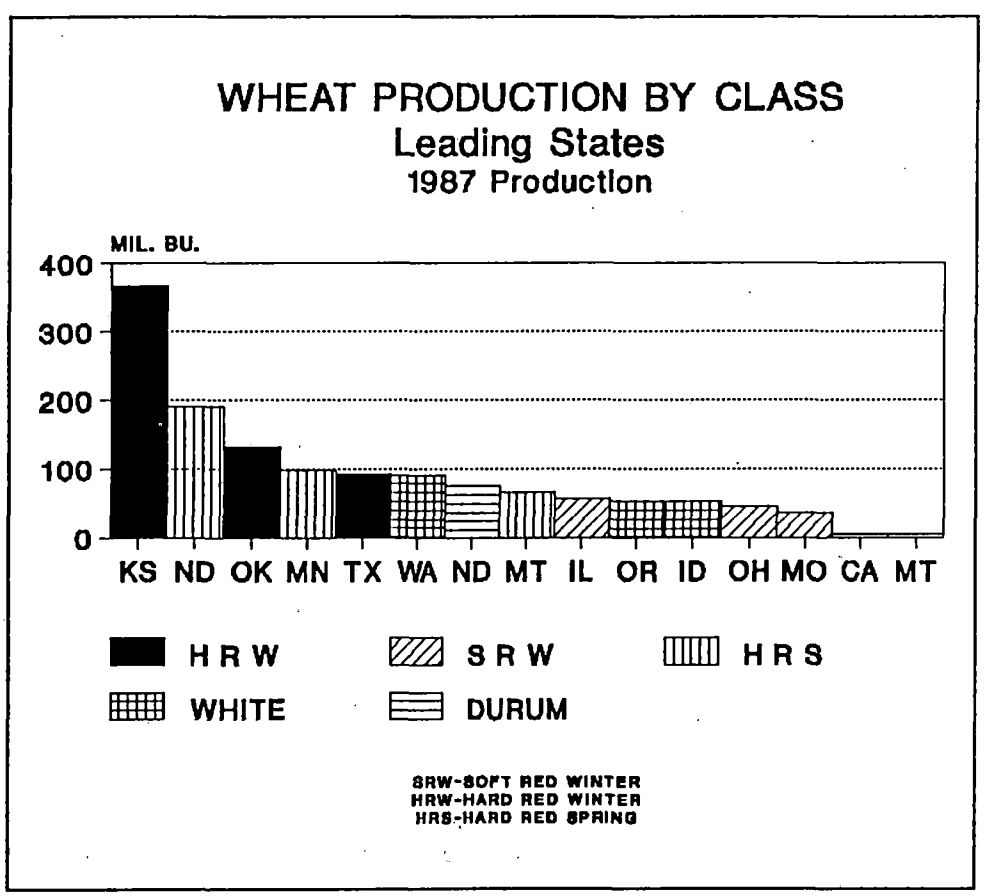


Wheat grown in the U.S. actually includes five distinct types: 1) hard red winter wheat; 2) soft red winter wheat; 3) hard red spring wheat; 4) white wheat; and 5) durum wheat. These distinct classes grow in different regions within the U.S. Their quality and market uses also vary. The wheat market,

in fact, is made up of several regional market segments and several distinct products. Figure 2.11 identifies the principal growing areas associated with the five distinct classes of wheat.

All the classes of wheat produced in the U.S. are suitable for export, although specific importing countries tend to prefer specific types. For example, in the 1980's, the principal importers of hard red winter wheat were the U.S.S.R., China, Iraq, Japan, and Morocco. China, Egypt, and Morocco were the principal importers of spring red wheat. Japan, Central America, the Philippines, and the U.S.S.R. imported hard red spring wheat primarily, while South Korea and Japan imported primarily white wheat. Large volumes of U.S. produced white wheat also move from year-to-year, depending on global market conditions and home market requirements, to India, Pakistan, and Egypt. Little

Figure 2.11



Source: Statistical Abstract of the U.S. 109th Ed.

durum wheat, however, is exported from the U.S. Durum wheat is used almost exclusively in the production of pasta for domestic consumption. Much of the marketing efforts of rail carriers during the 1980's were spent on understanding and analyzing alternative regional and global producers and substitute whole grain products. Each rail system is locked into a unique set of grain production economics that collectively define their service "franchise."[11]

In general, wheat production is less subject to the vagaries of climate and crop competition than is corn or soybean production. Thus wheat yield tends to be more stable year-to-year than the yield of either of these competing crops. Its cost of production is also generally lower than either corn or soybeans and its irrigation requirements less stringent.[12]

Demand for wheat in domestic food processing uses is relatively unaffected by world market prices and macro-economic conditions. Indeed, domestic demand is closely correlated with population growth.[13] Between 1980 and 1988, average annual consumption of wheat based flour increased from 117 lbs per capita to 128 lbs. Domestic demand for livestock feed, however, is highly variable. As a livestock feed, wheat competes directly with corn and soybeans. However, the staggered seasonal availability of these competing grains dampens some of this competition. Most wheat is fed to livestock during the June to August period when wheat supplies are most abundant and corn and sorghum supplies least abundant. During the summer months, wheat prices are seasonally low and prices for sorghum and corn seasonally high.

The size of the global market for wheat has more than doubled between the 1960's and 1980's. However, the participation of U.S. based growers in this market declined sharply until the late 1980's. In the period 1981 to 1986, U.S. producers fell well below their historical world market share of 40%. Only

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[11] Harwood, Joy L., C. Edwin Young, Wheat: Background for 1990 Farm Legislation, U.S. Department of Agriculture, Economic Research Service, p.13.

[12] Ibid, p.2

[13] Ibid, p.10

in 1987 and 1988 did U.S.-based producers reclaim their historically strong market position.

The price volatility of world wheat markets also increased markedly in the 1980's. This development was due in part to currency value fluctuations, in part to national farm policies that tended to reduce excess inventories in many nations, and, in part, to the export subsidy programs of the U.S. and European Community.

U.S. farm policy continues to play an important role in determining the competitiveness of U.S. producers. Historically, the U.S. operated a wheat storage program that absorbed much of the shock resulting from short-term fluctuations in the world market. However, U.S. farm policies were redefined under the 1985 Farm Assistance Act, with the result that U.S. producers have become more subject to rises and falls in world market prices.

2.4 FUNDAMENTALS IN THE SOYBEAN MARKET

Over the entire 1980's, the soybean market experienced essentially zero growth. Soybean traffic volume increased only 4.5% between 1978 and 1988. During this period, year-to-year domestic consumption was erratic. Export activity was similarly erratic but generally trended downward, as shown in Figure 2.12. Indeed, by the end of the decade soybean export volume had fallen off by more than 30% from the 1982 high. Still, the soybean market is a railroad success story (Figure 2.13). In spite of zero growth in the underlying commodity market, the rail share of this market increased markedly, from 18.2% in 1978 to 28.9% in 1988. At the same time, barge tonnage remained relatively constant. Truck tonnage declined sharply. Figure 2.14 illustrates the major soybean producing states.

Figure 2.12

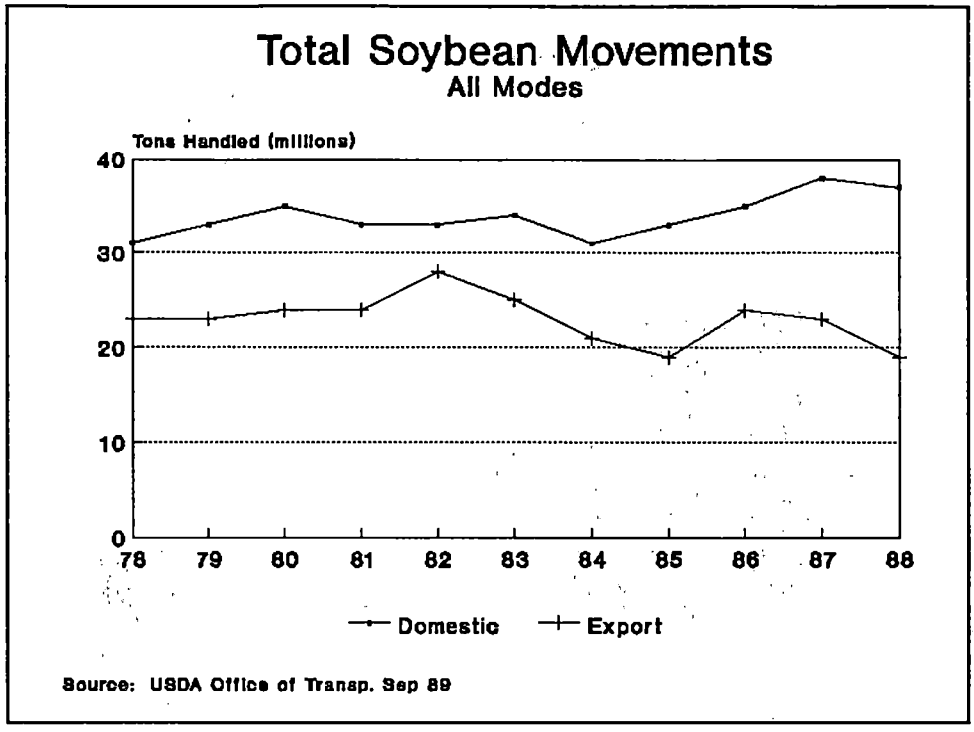


Figure 2.13

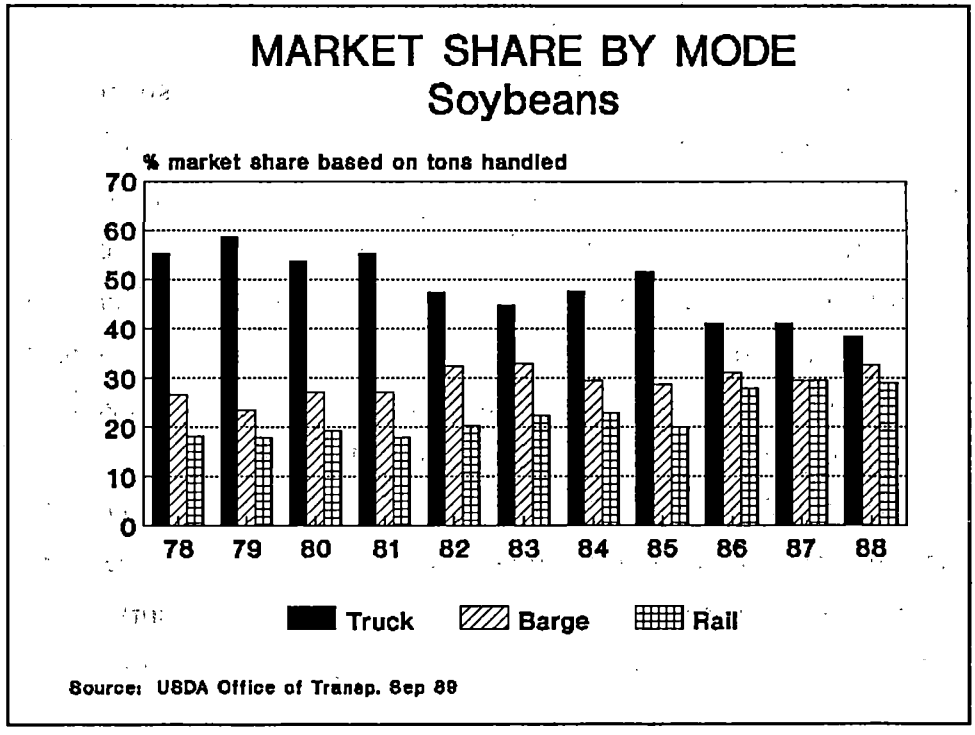
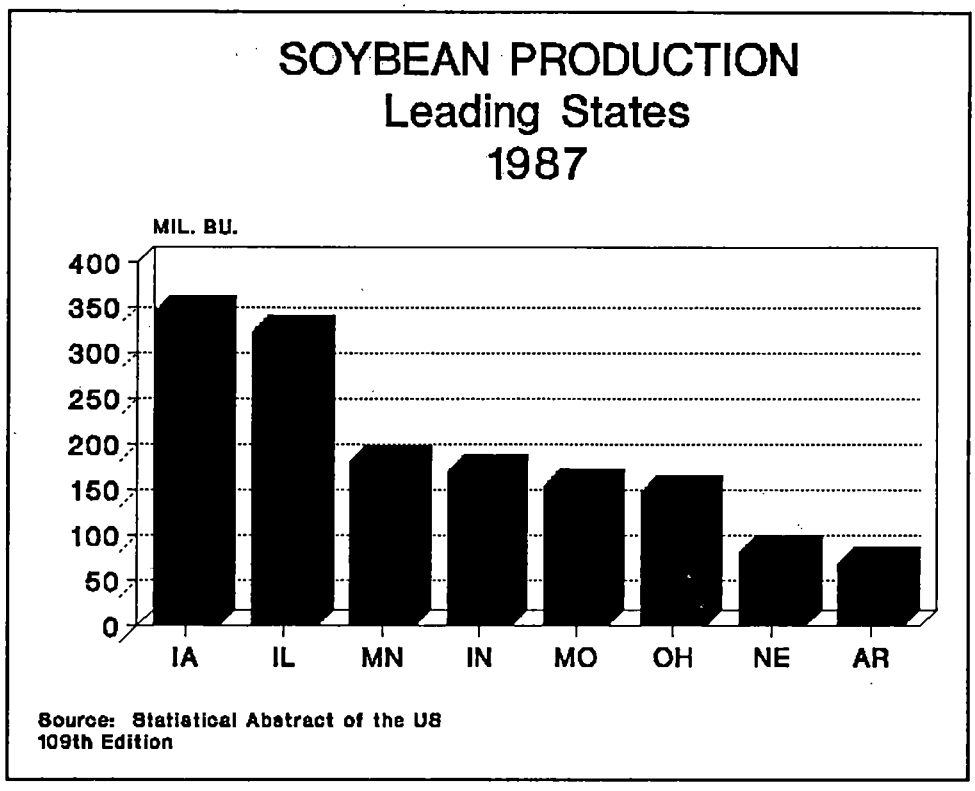


Figure 2.14



Two principal intermediate products are produced from soybeans: meal and oil. Soybean meal is the principal protein supply used to feed both livestock and poultry. It supplements other feed grains, as a nutritional source for livestock. However, it also competes directly with alternative feeds based on its nutritional value per dollar of delivered product. As a result, farm support policies affecting corn, wheat and other feed grains also affect the competitiveness of soybeans. Approximately 75% of U.S. soybean meal is consumed domestically. The remainder is exported.[14]

Soybean oil is the principal domestic source of edible oil products. It accounts for more than three quarters of all domestic food oils. Soybean oil accounts for a much smaller, but still significant (three percent), portion of inedible oils. Soybeans play only a minor role in the industrial market. Low

[14] Crowder, Brad, Cecil Davison. Soybeans: Background for 1990 Farm Legislation, U.S. Department of Agriculture, Economic Research Service, Sept. 1989. p.6.

cost petroleum products dominate the industrial oil products market. Most soybean oil is used domestically (80% to 90%).[15]

In spite of the fact that the U.S. share of this global market has declined markedly in recent years, the U.S. remains the leading exporter of soybeans. Higher world market prices for soybeans in the 1970's encouraged the rapid entry of Brazil, and Argentina, and most recently China, into soybean production. In spite of increasing world demand for soybean meal and vegetable oil, U.S. exports have fallen off sharply from their 1981/1982 peak. The rise of the U.S. dollar and increased competition from foreign producers are the principal causes of this export decline. The principal importers of soybeans and soybean derived products include the European Community, Japan, Taiwan, Mexico, and South Korea. Demand for soybeans in foreign countries is closely linked to rising real incomes and increased consumption of livestock products.[16]

2.5 MARKET SHARE SHIFTS

During the 1980's, significant shifts have taken place in the market share of grain products handled by specific rail carriers even after merger effects are taken into account. For example, in the corn market, Eastern roads have generally lost market share to Western roads, as shown in Figures 2.15 and 2.16. Norfolk Southern (NS) has lost a substantial portion of its originated corn market and surrendered its number one share ranking, while both Burlington Northern (BN) and Union Pacific (UP) have increased their shares and assumed market leadership positions.

Market share in the wheat market appear to be more stable (Figures 2.17 and 2.18). In this market the Burlington Northern, Union Pacific, and the Atchison, Topeka and Santa Fe Railway (ATSF) preserved leadership positions for most of the decade. Only in 1987 and 1988 did the ATSF challenge the Burlington Northern for top ranking. An interesting story in the wheat market

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[15] Ibid. p.13

[16] Ibid, p.13

Figure 2.15

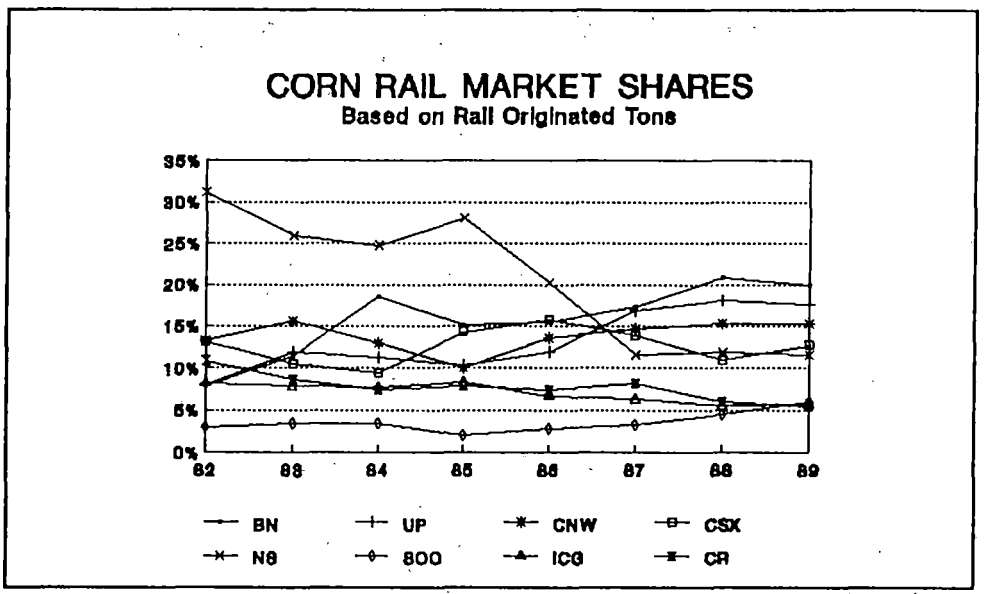
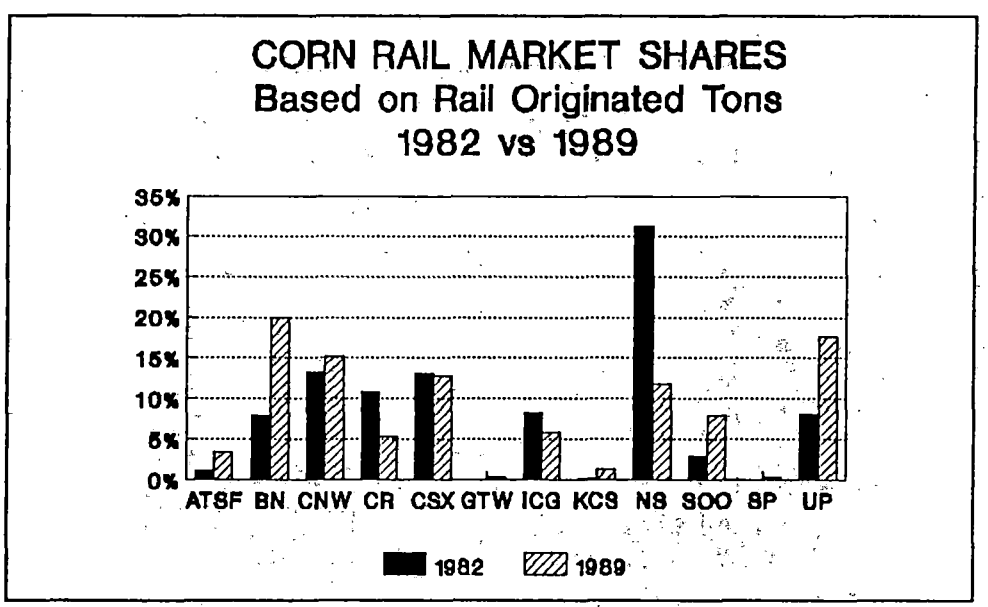


Figure 2.16



Source: Quarterly Commodity Statistics (QCS) for Corn

Figure 2.17

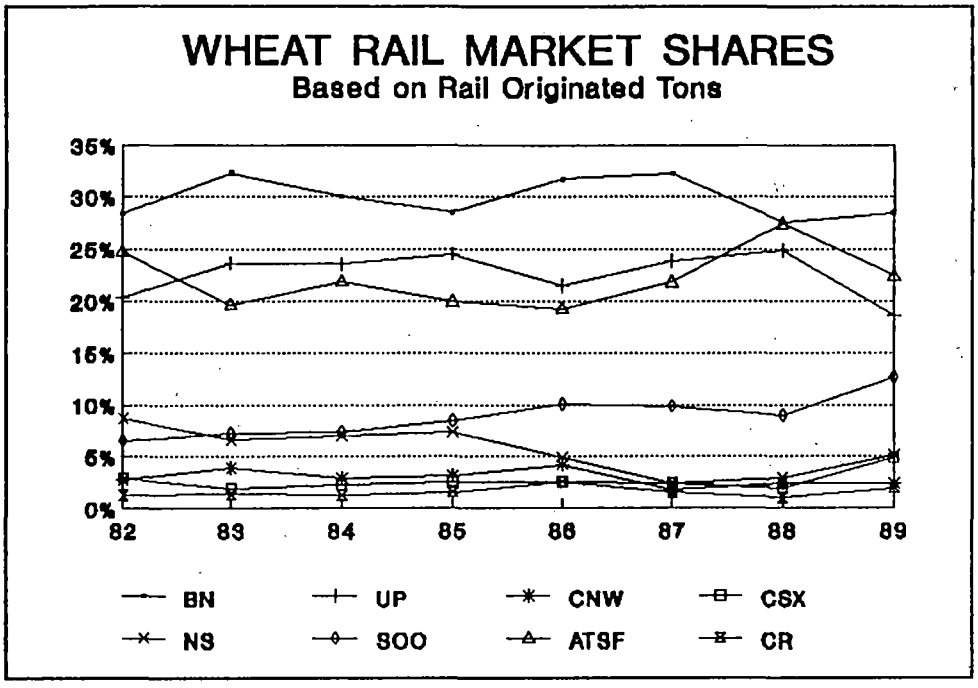
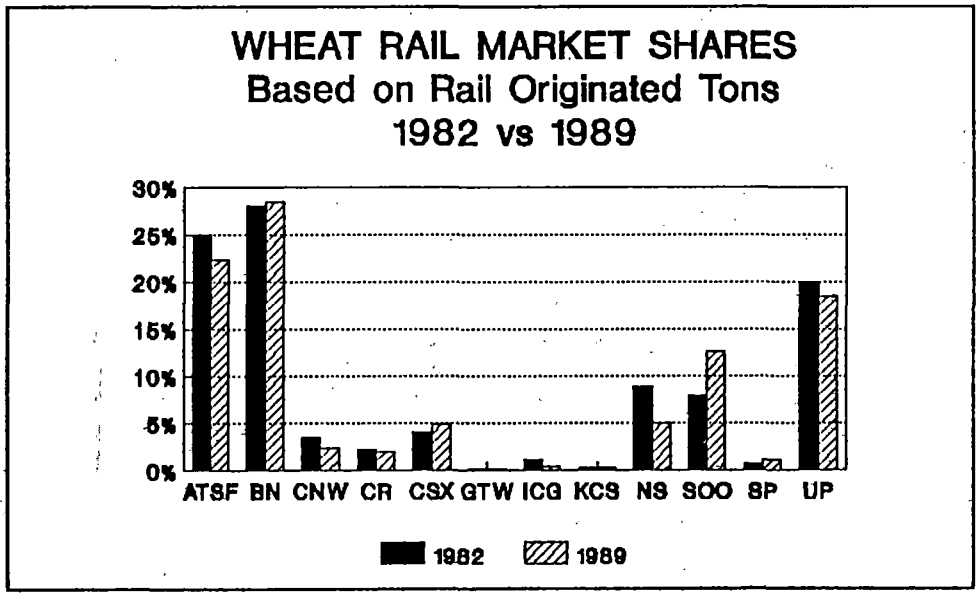


Figure 2.18



Source: QCS for Wheat

is the marked increase in Soo Line's market share since 1986.

The soybean market demonstrates even more volatility (Figures 2.19 and 2.20). As in the market for corn, Norfolk Southern appears to have lost a substantial portion of its market share during the 1980's. The largest market share gains have been realized by the Burlington Northern and by CSX Transportation (CSX). In recent years, both of these roads have vied for market leadership.

Figure 2.19

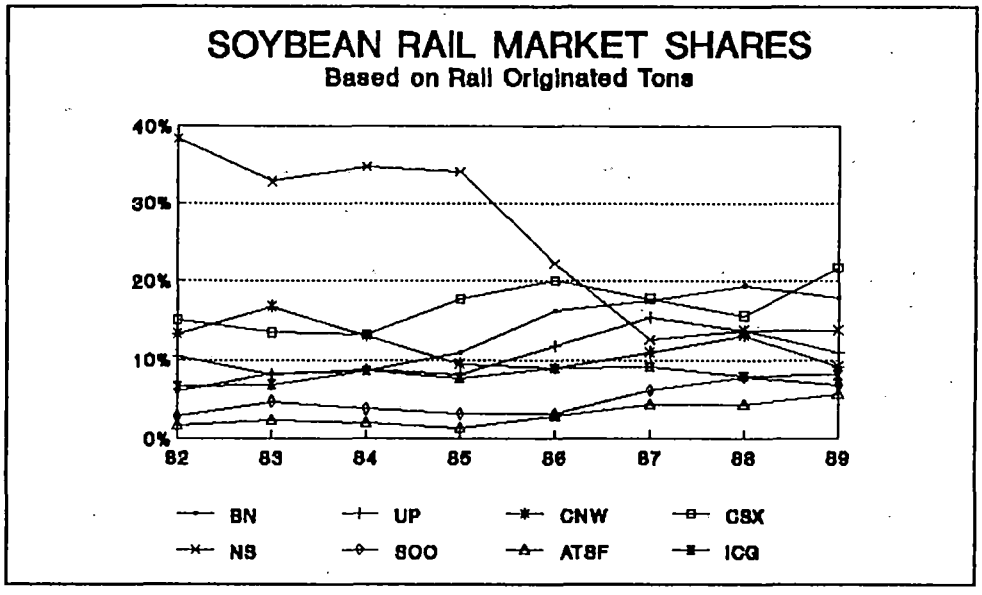
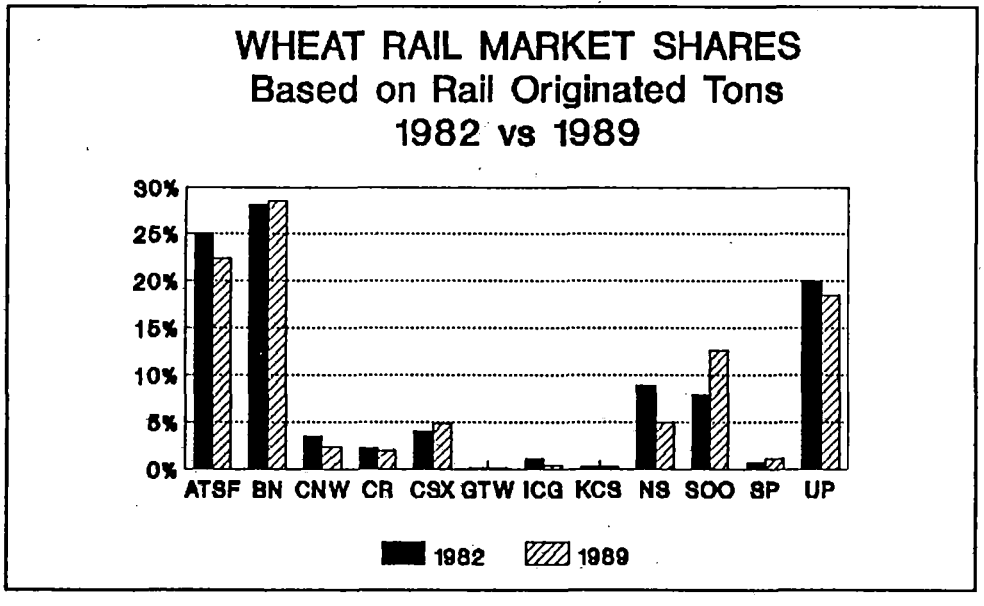


Figure 2.20



Source: QCS for Soybean

3.0 THE EVOLUTION OF GRAIN COMMERCIAL STRATEGY IN THE POST-STAGGERS ACT ERA

The Staggers Rail Act gave railroads greater freedom to set rates and to explore new commercial paradigms for marketing their services. In the broadest terms, the Act allowed carriers to shift their commercial emphasis from tariff based commercial mechanisms that traditionally offered the same rates for specific commodities to all shippers within broad geographical rate territories to other commercial paradigms -- paradigms more tailored to the needs of specific customers and less open to public scrutiny.

Shifts in these commercial paradigms had significant effects not only on grain shippers but also on other grain market participants. Over an extended period of time, before the Staggers Act, the rate relationships implicit in origin territory to destination territory tariff rate structures had become the "basis" for establishing the delivered price of grain. In adapting their commercial strategies, individual rail carriers steered between the dual constraints of maintaining non-distorting grain market mechanisms and the need to profitably adapt commercial policy to the local market over which individual carriers operated.

Title II of the Staggers Act established a regulatory framework under which fundamental shifts in commercial strategy were possible. It minimizes the regulatory involvement of the ICC in rate-making matters and restricts that involvement to matters in which a carrier can be proved to be "market dominant." Title II also closely circumscribes the participation of multiple carriers in collective rate making and strictly limits collaboration on interline prices to specific point-to-point movements.

Section 208 of the Act expands the scope of private contracts between shippers and carriers and defines the regulatory safeguards with which carriers must comply in contracting for services. This chapter discusses the evolution of rail commercial strategies that followed the Staggers Act. It describes in general terms the integration of contracting into the commercial strategy of rail carriers.

3.1 OVERVIEW

It is difficult to discuss the evolution of commercial strategy in general terms since, as we will explore in the following chapter, commercial strategy among carriers in the post-Staggers era has been most marked in its divergence and diversity. Indeed, commercial grain strategy can meaningfully be discussed only at the level of individual carriers.

As a point of departure, an explanation may be in order regarding factors that influenced commercial diversification. One of the most salient features of rail grain markets is the fact that relatively little grain moves between rail carriers on an interline basis.[17] This condition has fostered the development of many distinct, carrier-specific commercial strategies in the post-Staggers era. The limited amount of grain moving on an interline basis involves hard winter wheat moving inbound to eastern mills in official territory, mills served by CSX, Norfolk Southern and Conrail, as well as Great Plains wheat and corn originating on the C&NW and Soo Line moving to Gulf and Pacific Northwest ports. In the post-Staggers era, individual carriers have evolved commercial strategies designed to match the market conditions in their local service territory and to support their unique market with uniquely tailored commercial programs.

Still, the development of a commercial strategy in the more open post-Staggers environment has been an evolutionary process for most carriers, a process of trial-and-error. Indeed, the grain marketing strategy of many carriers has evolved through a multi-phased learning process. In this process carriers have been able to learn not only from their own commercial experience but also from the experience of other, sometimes competing, carriers.

As a broad generalization, which fits no individual carrier perfectly, this process of commercial evolution has progressed in three recognizable phases: 1) An initial experimental phase was characterized by aggressive pricing, the testing of the new contract freedom, and a painstaking re-assessment of the needs and requirements of each service franchise. For some carriers this initial

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[17] This circumstance has become more prominent in the 1980's with the formation of larger interregional rail systems and with the increased linkage of rail marketing programs with barge loading operations. Still, during periods of market stress (e.g. droughts, strong export demand, etc.) creatively designed interline movements do in fact increase in significance.

phase of commercial experimentation lasted only a short period of time. At Conrail, for example, it lasted less than one year. For other carriers, such as the Chicago and North Western (C&NW) and Illinois Central (IC), it lasted much longer. 2) A second phase was characterized by the development of formal commercial strategies designed to match the characteristics of each railroad's market. During this second phase, individual railroads developed and implemented distinct marketing programs based on market segmentation strategies, pricing policies and commercial standards for contracting -- all adapted to the specific markets where they operate. 3) The third phase of market development, which is only now beginning, is marked by competitive emulation, commercial strategy refinement and contract simplification. The principal objective of most carriers in phase three will be to improve profitability, either through incentives designed to encourage equipment utilization, or to increase revenue yields.

A more detailed review of these three market development phases will help to set the backdrop against which the effects of contract disclosure requirements on specific carriers can be better understood.

3.1.1 PHASE ONE: COMMERCIAL EXPERIMENTATION

Rail deregulation was introduced in a grain market environment characterized by slow growing or declining demand, surplus car capacity, and weak commodity prices. As we will discuss in detail in the chapter that follows, phase one in the commercial evolution of most carriers was characterized by a scramble to lock in business and to exercise the newly-acquired contracting freedom aggressively, in an effort to increase market share. Phase one was a competitive free-for-all. During this period, railroads negotiated a diversity of contracts with a diversity of market participants: origin elevator operators, middlemen brokers, international grain merchants and export elevator operators. This period witnessed a rapid deterioration in rate levels, with little net increase in grain volume. In the process of contracting with multiple parties, multiple allowances were sometimes negotiated for individual movements to origin shippers, to middlemen and to destination shippers. This

"double dipping" phenomena was the source of additional yield depletion, over and above the rate-depressing effects of contract competition. These effects have been thoroughly documented in recent ICC and GAO studies.[18]

This initial phase was also marked by commercial experimentation. The objectives, which drove most commercial experimentation during this period, were market share increase and/or market share preservation. Unfortunately, phase one coincided with an extremely soft grain export market and a slow growth domestic market. Many railroads operated with excess car capacity during the period 1980 to 1985.

3.1.2 PHASE TWO: STRATEGY FORMALIZATION

The second phase of market development evolved as specific carriers developed formal strategies adapted to the needs and competitive circumstances of the shippers they served, as well as to their local market conditions. The BN, for example, serves markets characterized by high peak-seasonal demand and high year-to-year volatility. BN markets have a strong export orientation. The geographic competition BN faces in maintaining the world market competitiveness of North Dakota grain elevator operators is essentially different from the challenge CSX faces in moving Ohio and Indiana grain into North Carolina poultry processing plants.

CSX markets are more stable seasonally, have a strong domestic orientation, and have been marked in recent years by steady growth of 4 to 6 percent per year. However, CSX faces more intense regional competition from other transportation modes and from its principal regional rail competitor, Norfolk Southern. The Burlington Northern, on the other hand, serves broad grain-gathering areas to the exclusion of competing rail carriers.

The essential determinations made by individual rail carriers in the second phase of market development represent answers to the following questions, which taken in aggregate, represent the basic elements of a full

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[18] See Ex Parte No. 387 (Sub-no. 953); Contract Rate Competitive Impact Report - Grain Suppliers, Feb. 1989, prepared by the Office of Transportation Analysis, Interstate Commerce Commission. Also see Railroad Regulation Economic and Financial Impact of the Staggers Act of 1980, May 1990, prepared by the Government Accounting Office.

blown commercial policy:

- Who is the customer?
- What strategic market objectives are being pursued through contracting?
- What should be the commercial relationship between tariff rates and contract rates?
- What classes or segments of the market require distinct and individualized treatment?
- What, if any, should be the relationship between rail price levels and grain market prices?

CSX, to take one carrier example, set out to develop a new domestic market for feed grains -- a market centered around the Southeastern poultry and livestock feeding industries. To encourage more feed processors to locate on CSX lines, and to encourage existing ones to expand their operations, CSX implemented a policy in 1985 to contract exclusively with destination grain buyers including feed mills, grain processing plants and export elevator operators. The events leading to this policy are revealing.[18]

Soon after deregulation, CSX learned that it could not satisfy grain elevator operators with discounted prices. In post-Staggers negotiations, origin operators continually sought competitive advantage over one another in the form of more deeply discounted rail rates. In these negotiations, the only volume commitments origin grain elevator operators were willing to make were contingent commitments of the following sort: "If I have a good enough rate, I will move large volumes of freight over your railroad."

CSX decided that, in its service territory, transportation control could most advantageously be given to end-market receivers. In any case, receiver processing plants were the operations CSX marketers wanted to expand. The result was the implementation of a demand-pull strategy. Depending on

[18] Based on discussions with CSX grain marketing managers.

commodity price levels and grain quality, receivers sourced their grain from alternative elevators each season. By contracting at the destination, CSX was able to give receivers, whom the railroad served, sufficient contract flexibility to source from alternative suppliers.

The Burlington Northern has followed a fundamentally different strategy in the second phase of market strategy evolution.[20] The Burlington Northern does not contract exclusively with either grain buyers or sellers. Indeed, the Burlington Northern does not become actively involved in linking specific origin and destination market makers. Instead, it sells fungible Certificates of Transportation (COT's). These are "tradeable" calls for future transportation services. COT's are flexible enough to cover a broad array of transportation services -- unit train, multiple-car, etc.

These two strategies -- CSX's and BN's -- represent two distinct commercial paradigms. Others have emerged in the second phase of commercial development.

3.1.3 PHASE THREE: COMPETITIVE EMULATION AND STRATEGY RETIREMENT

The third phase, which we are entering now, can be characterized by competitive emulation among carriers and commercial policy refinement within specific service territories. An objective shared among most carriers in the third phase is to increase yields and/or to improve profitability through improved operating efficiency. In an effort to improve yields, carriers are increasingly moving towards tariffs, which have historically acted as a rate ceiling in contract negotiations. Contract rates have typically been set at a level below tariff rates. The period for commercial experimentation appears to have passed. Rail CEO's expect their grain marketers to deliver results in the form of improved profitability. As we will discuss in detail in the following chapter, in this third phase, some carriers continue to contract with both origin elevator operators and with receivers. However, the trend within the industry is to

[20] Based on discussions with BN grain marketing managers

contract more and more with destination receivers.

Two secondary objectives that appear to be shared by rail carriers in phase three are to reduce the number of outstanding contracts and to simplify contract terms. These objectives reflect, in part, market pressures for simplification and standardization. These pressures, in turn, reflect the fact that the disclosure rules affecting grain contracts became effective near the end of the second market development stage for many carriers, and disclosure rules tend to impose a strong centripetal pressure on commercial strategy, as we will discuss in a subsequent chapter.

3.2 CONTRACT COMPETITION

Rail grain contracting activity averaged 597 contracts each year for the period October 1980 to 1983. Contract competition heated up in 1984 and 1985 when rails negotiated 1,544 and 3,337 contracts respectively (Figure 3.1).

The grain contracting activity of several major railroads, however, appeared to peak in 1985/1986 after rising steadily from a 1980 base. Roads including the ATSF, Soo Line, IC, UP, Southern Pacific (SP), CSX, and NS all demonstrated the same general trend: Total contract activity continued to increase from 1980 through 1985/1986. However, contracting activity fell off from 1985/1986 peak levels in 1987 and in the years that followed. This general trend, illustrated in Figure 3.2, clearly indicates a shift in commercial policy in 1986 or 1987 -- a shift that represents the end of Phase One and the beginning of Phase Two in commercial strategy development for several carriers.

Figure 3.1

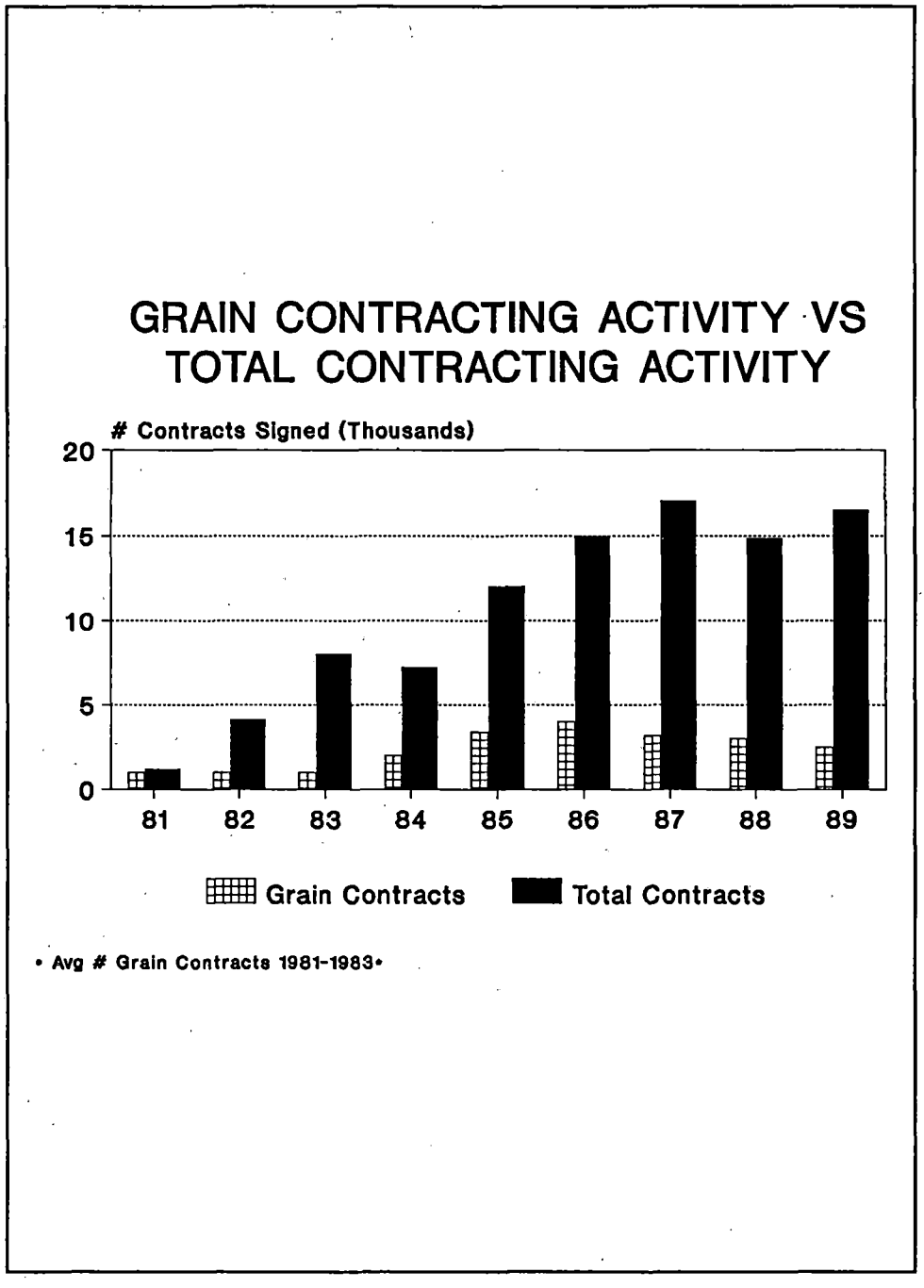
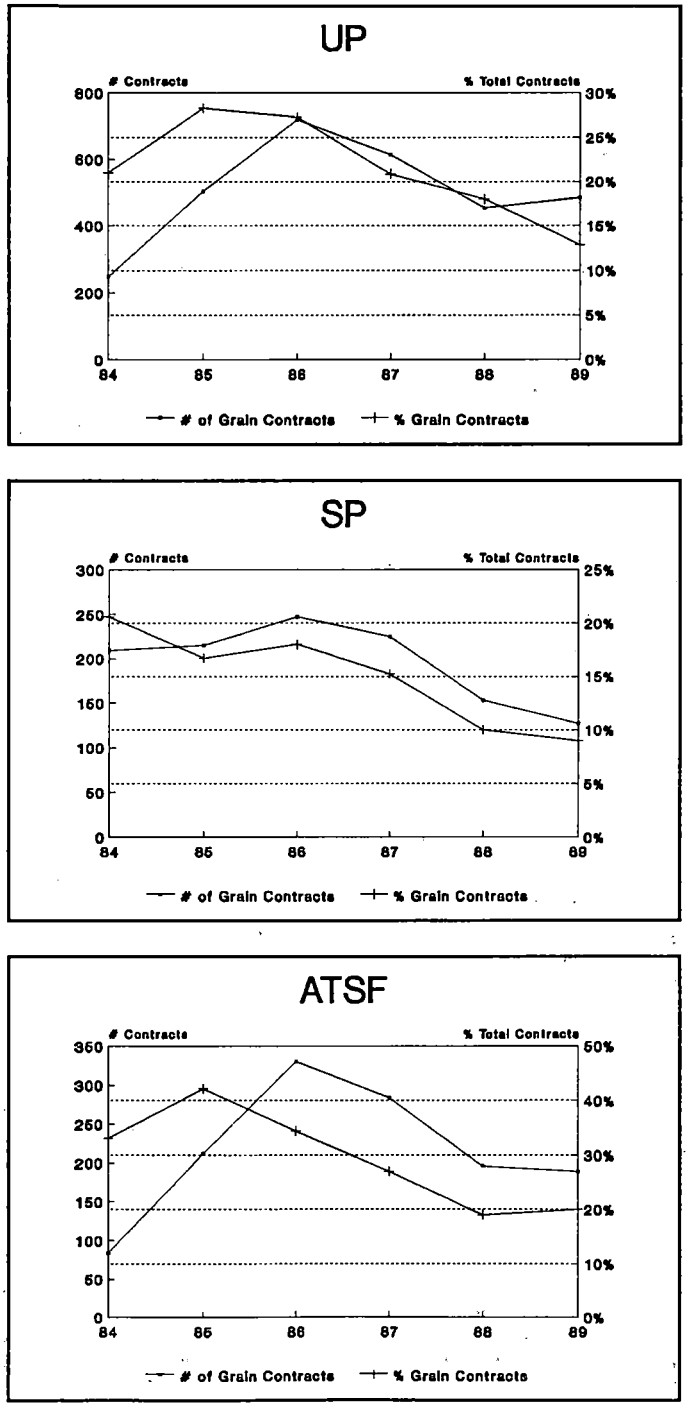
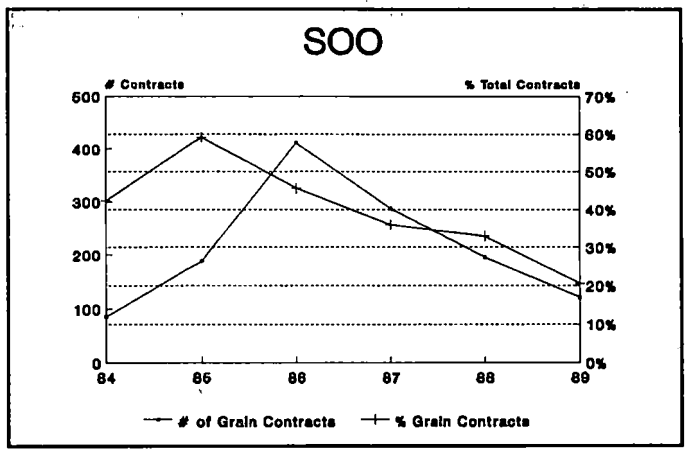

GRAIN CONTRACTING ACTIVITY VS
TOTAL CONTRACTING ACTIVITY
Contracts Signed (Thousands)
20
15
10
5
0
81
82
83
84
85
86
87
88
89
Grain Contracts
Total Contracts
• Avg # Grain Contracts 1981-1983•

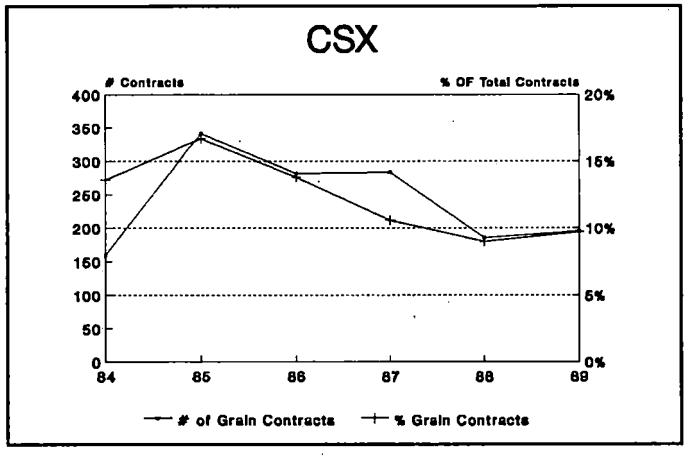
Figure 3.2
GRAIN CONTRACTING BY MAJOR GRAIN HAULERS

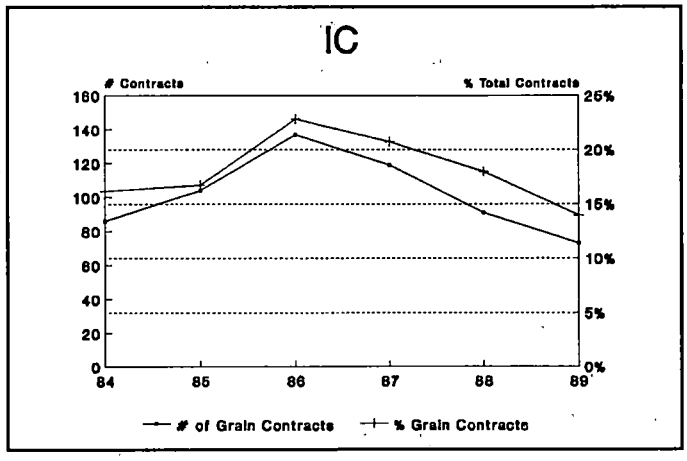


Source: ICC Railroad Contract Summary File

Figure 3.2A
GRAIN CONTRACTING BY MAJOR GRAIN HAULERS



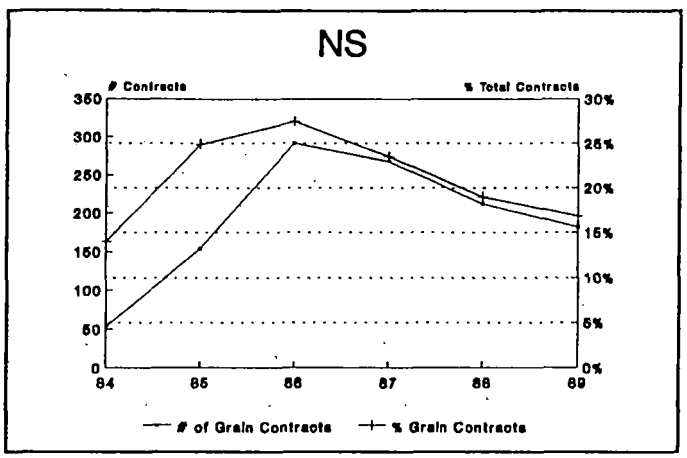




Source: ICC Railroad Contract Summary File

Figure 3.2B

GRAIN CONTRACTING BY MAJOR GRAIN HAULERS



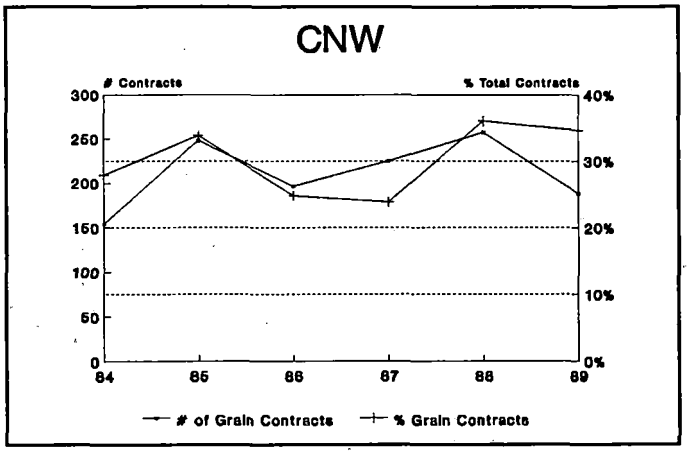
Source: ICC Railroad Contract Summary File

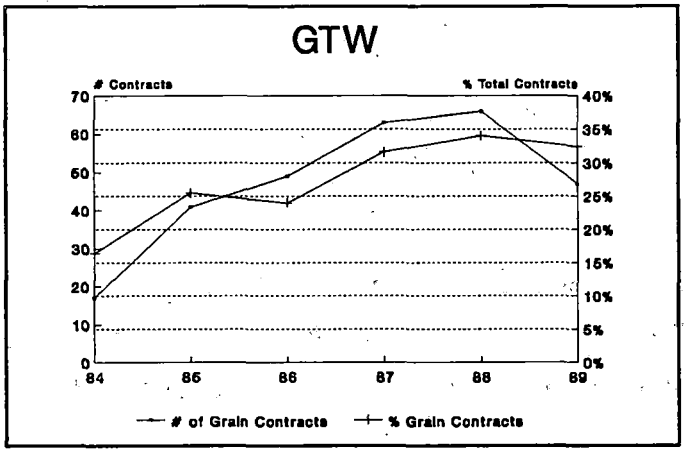
Other major carriers including BN, Grand Trunk Western (GTW), C&NW and Conrail (CR) as well as smaller regional carriers demonstrated quite different patterns of grain contract activity, as shown in Figure 3.3.

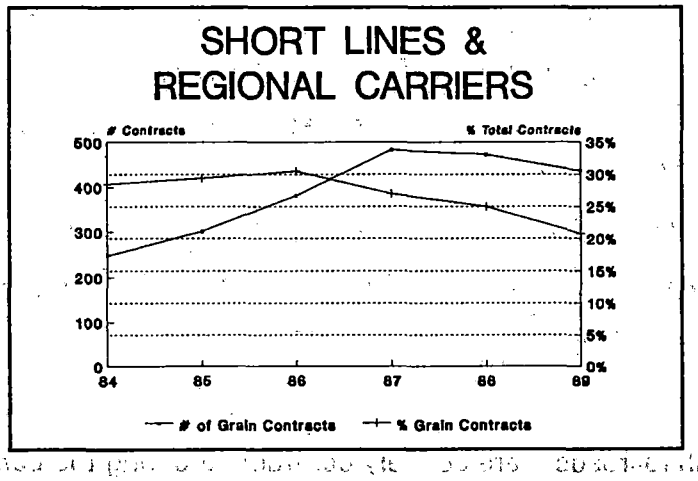
C&NW, for example, demonstrated no significant reduction in grain contracting activity over the period 1984 to 1987/88. Conrail reduced its grain contracting activity in 1987, only to increase it in 1988, and reduce it again in 1989. The GTW continued to pursue grain contracts aggressively in 1987 and 1988, even when contract activity in its other markets had begun to recede. This diverse behavior suggests that these carriers were pursuing distinct and essentially different commercial strategies.

Figure 3.3

UNIQUE GRAIN CONTRACTING ACTIVITY OF SPECIFIC RAILROADS



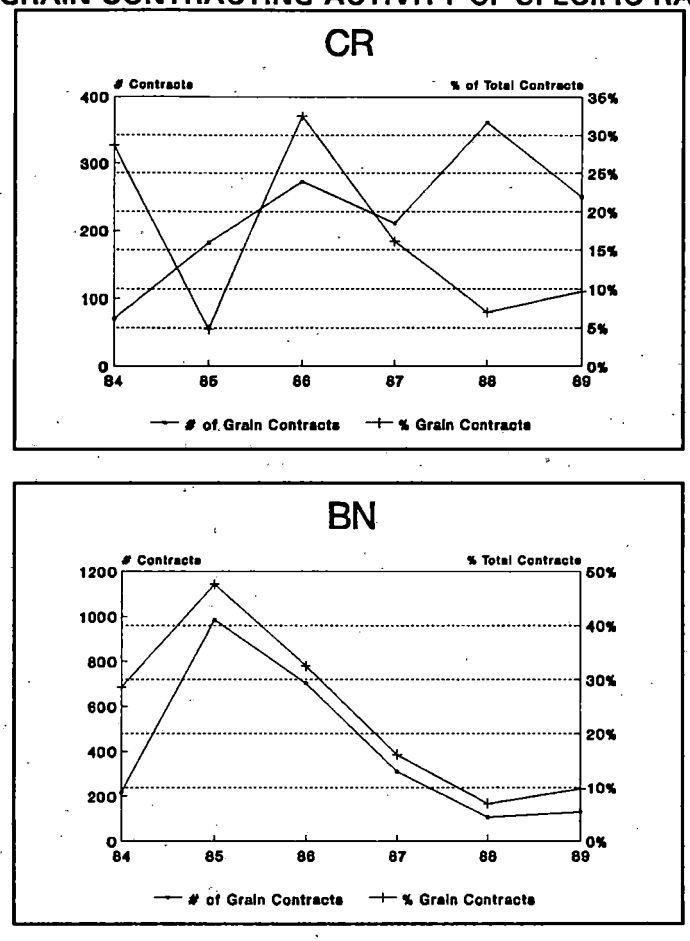




Source: ICC Railroad Contract Summary File

Figure 3.3A

UNIQUE GRAIN CONTRACTING ACTIVITY OF SPECIFIC RAILROADS



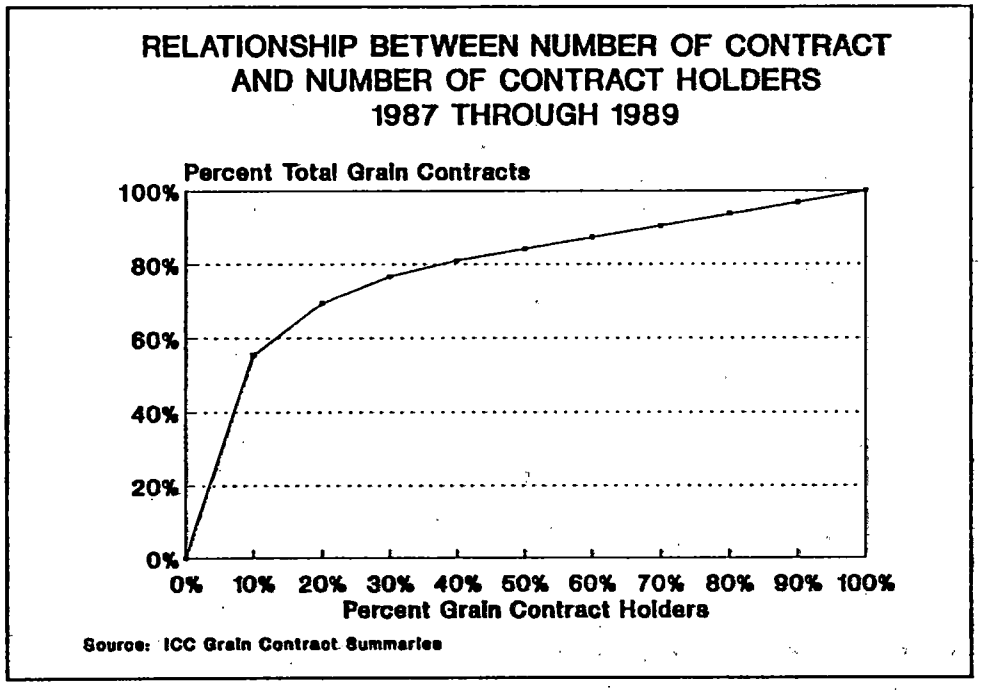
Source: ICC Railroad Contract Summary File

The most interesting situation, however, is that of the BN, where grain contracts peaked in 1985 and fell off rapidly in 1986, 1987 and 1988 to a near zero level in 1989. A similar but less dramatic effect can be observed on the Soo Line, where grain contracting activities peaked in 1986 and then fell off rapidly thereafter to a low level (Figure 3.2A).

Although railroads were actively contracting during the period 1985 to 1988, these contracts were concentrated among relatively few shippers. Ten percent of total grain contract holders account for more than 55% of the

contracts negotiated (Figure 3.4). Indeed, the top twenty percent of contract holders account for 70% of all contracts filed. A large number of contracts have been negotiated with large grain marketing companies -- Bunge, Cargill, Conagra, Continental Grain, Elder, Louis Dreyfus, and Union Equity, for example, account for fully 32% of all contracts. Large food processing companies, including Archer Daniels Midland, General Mills, Pillsbury, Purina, and Quaker, likewise account for a notably large share of contracts.

Figure 3.4

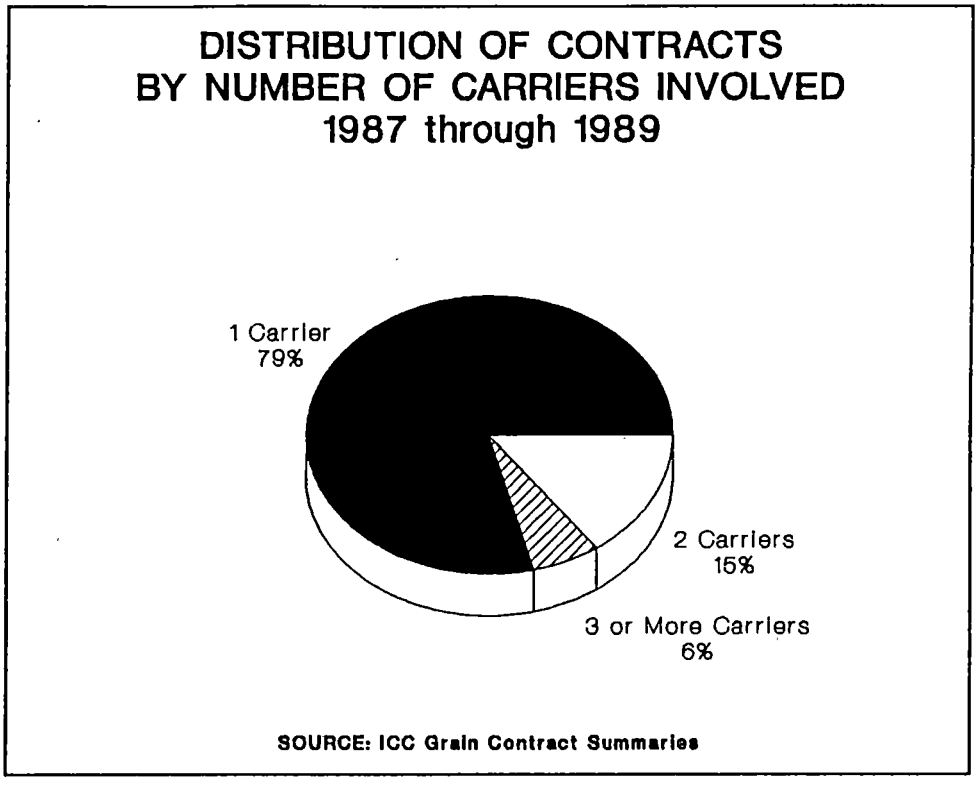


Contract Elements

Detailed information concerning rail grain contracts is available only from grain contract summaries filed with the Interstate Commerce Commission since February, 1987. Detailed information on grain contract provisions for years prior to 1987, before contract disclosure rules were finalized, is not available. An analysis of a random sample of contract summaries (see Appendix B) filed with the Commission since 1987 indicates that almost 80% of the grain contracts filed involve single rail carriers (Figure 3.5). Only 15% involve two

rail carriers and only 6% involve three or more carriers. These percentages vary among carriers depending on their specific market and on whether cooperative or competitive relationships exist with connecting carriers.

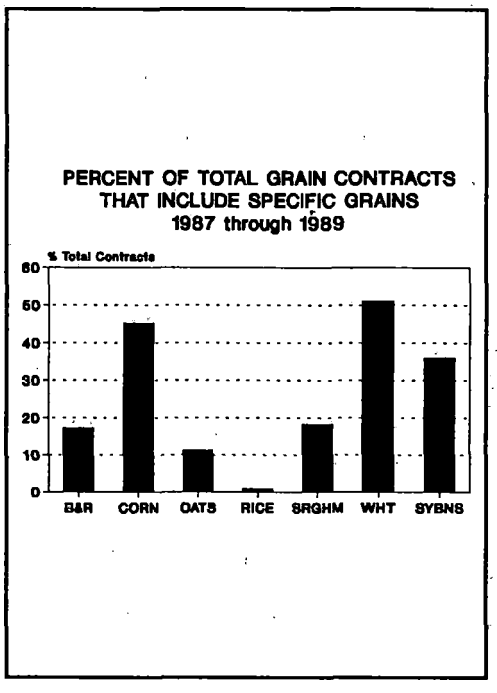
Figure 3.5

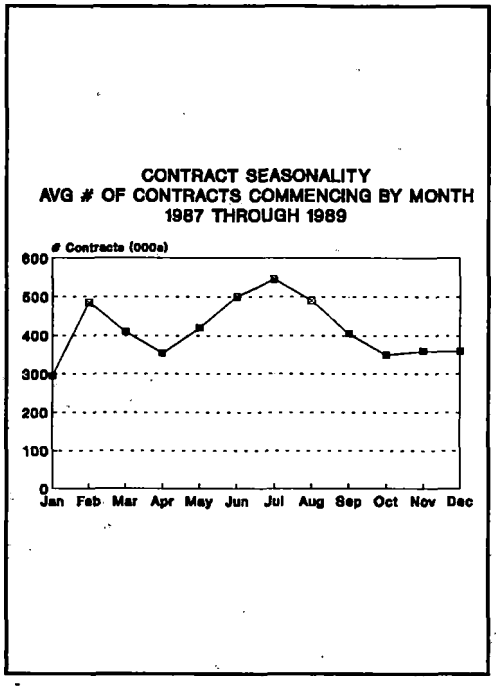


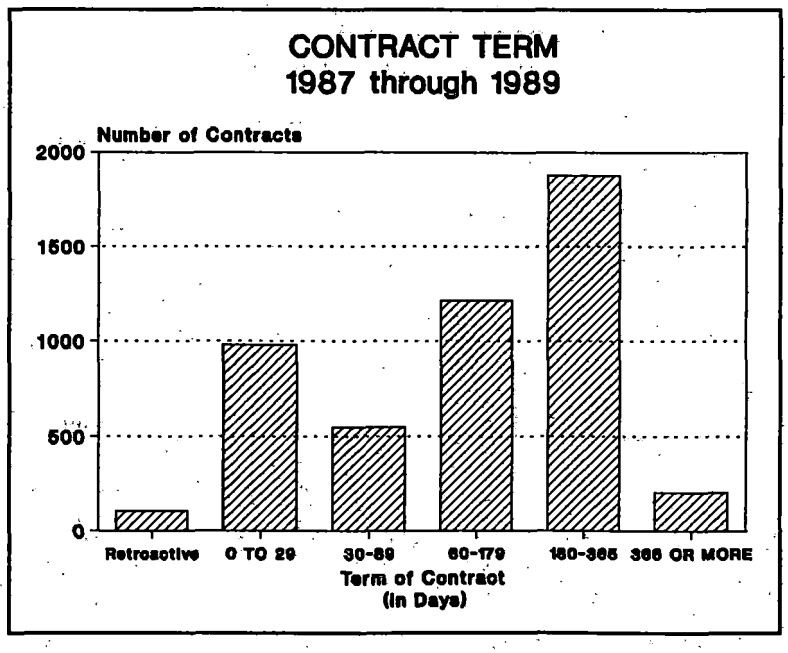
A large number of rail contracts include two or more grains. The largest percent of contracts include wheat (52%). The second most frequently included commodity is corn (45%). Soybeans follow in third place. Soybeans are included in fully 37% of all grain contracts. Figure 3.6 shows the percent of total grain contracts that include specific grains, number of contracts commencing by month and the distribution of contract terms. The largest number of contracts are for terms between 6 and 9 months. The commitments that carriers are willing to offer in their contracts with shippers vary considerably. They are, to a large extent, driven by the leverage a shipper can bring to bear on the railroad, and by competitive factors. Figure 3.7 shows the distribution of various carrier commitments included in grain contracts for the three year period starting from February, 1987. Almost 36% of all the

commitments involve movement of grain at or below tariff rates, 21% under special rates, which do not reference tariff rates, and 10% involve refunds.

Figure 3.6

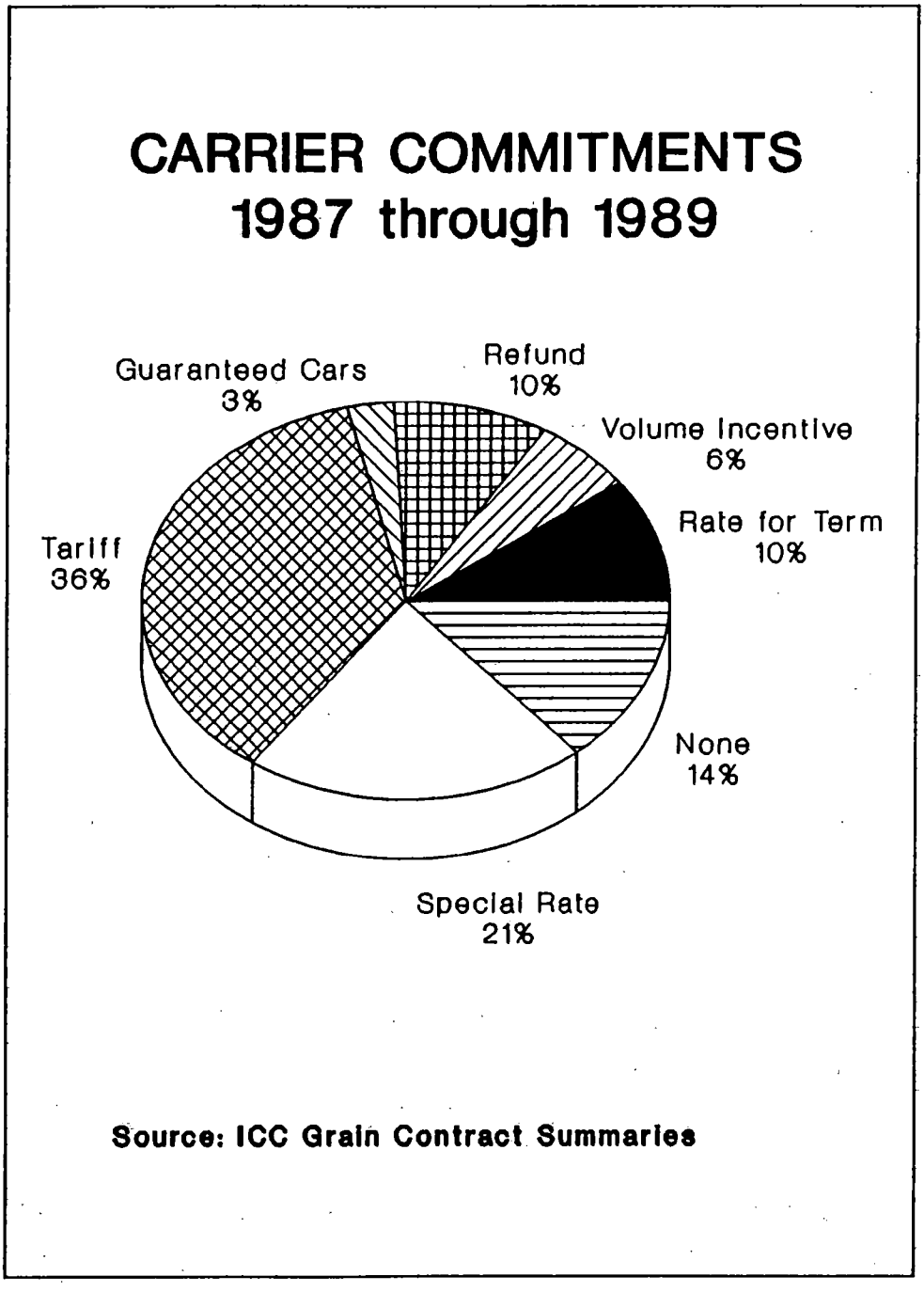






Source: ICC Grain Contract Summaries

Figure 3.7



Source: ICC Grain Contract Summaries

4.0 COMMERCIAL STRATEGY DEVELOPMENT OF SPECIFIC CARRIERS

Since the implementation of the Staggers Act, the grain marketing strategies of various railroads have evolved in distinct and unique directions. Some carriers have developed commercial strategies that rely heavily on annually negotiated large volume contracts. Other carriers have developed strategies that avoid contracting altogether. The effects of contract disclosure requirements vary substantially among individual railroads depending on the specific commercial paradigms these carriers have adopted since deregulation and the specific objectives they have attempted to realize through contracting.

This chapter reviews the evolution of grain marketing strategy of four railroads, who are among the principal grain handling railroads in the U.S. We developed the data that supports the commercial profiles of specific carriers in a series of structured interviews with grain marketing officials within carrier organizations and with shippers. The technical appendix to this report describes the survey methodology we used to develop information on carrier grain marketing program development during the period in which disclosure was being implemented. The appendix also outlines the evolution of the grain strategies of other railroads, in addition to the four discussed here. In this chapter, we attempt to address the following issues:

- *What has been the experience of individual carriers in adapting their commercial strategies to a deregulated environment?*
- *What effect has contract disclosure had, if any, on shaping the commercial strategy of individual carriers?*
- *What commercial initiatives, if any, have been inhibited by contract disclosure?*

A careful reading of the following commercial profiles will reveal far-ranging commercial experimentation and a diversity in commercial strategy development that clearly continues within the rail industry--experimentation and diversity that are the direct result of deregulation. It will also reveal a convergence, in most cases, between the commercial strategy of individual carriers and the requirements of their underlying market.

4.1 EMERGENCE OF NEW COMMERCIAL PARADIGMS

The single clearest message that emerges from a close review of post-Staggers Act commercial strategy is the diversity of individual carrier strategies and the close fit between carrier marketing programs and the market underlying each service system. As one carrier executive explained during our interview with him: "Everyone has a place in the grain market. Articulating a sound commercial strategy is really a process of finding your place in the market."

Individual carrier commercial strategies vary in a number of essential ways. Most importantly, they vary in the strategic objectives they are designed to achieve. One of the clear results of the new ratemaking flexibility and contracting freedom available under the Staggers Act has been the zero-based review of first principles around which carriers have redesigned their commercial strategies.

Several rail carriers have set as strategic objectives the leveling of demand in highly volatile export markets. Other carriers have set as objectives the development of new on-line processing industries or the opening of new off-line markets previously closed to their origin elevators. Still other carriers have attempted to use contracts to enhance the market value and the end market access of their origin elevators.

However, even identical strategic objectives can lead to different commercial strategy solutions in the post-Staggers market. For example, two carriers whose service franchise covers large grain production areas, both of whom traditionally originate large surplus volumes of wheat, corn, and soybeans for off-line processing plants and export elevators, have evolved dramatically different marketing strategies. One carrier -- the C&NW -- has attempted to develop a solid business base in master contracts. This carrier perceives large receivers with multiple off-line grain processing mills, terminal elevators, and export elevators to be its principal customers. The C&NW's objective in contracting is to allow maximum flexibility to its producers and to open as broad an off-line grain market territory as possible. This carrier structures its contract terms hierarchically, allowing the most preferred terms to a limited number of grain merchandisers who are prepared to make the

largest annual volume commitments to gather grain within the carrier's service territory.

The second carrier who appears, at least on the surface, to operate in a service franchise with similar attributes has arrived at a very different solution. This carrier -- the Soo Line -- perceives its country elevator operators to be its principal customers. It works closely with these country elevator operators to adjust its rate structures and to furnish adequate levels of leased equipment in order to satisfy seasonal and highly volatile equipment needs. Communication and close linkage with on-line shippers are used to fine tune the carrier's tariff levels on a frequent basis. The carrier uses contracts very sparingly; indeed, only in circumstances where quick response is essential to market participation. The "customer friendly" tariffs this carrier has developed include point-to-point customer-tailored rates.

Numerous other distinct commercial paradigms have emerged in the post-Staggers era. The most innovative, perhaps, is the strategy the Burlington Northern has built around its Certificate of Transportation Program (COT's) discussed below in section 4.2.2.

Figure 4.1 characterizes the grain marketing programs of the principal grain hauling railroads, in general terms. The remainder of this chapter reviews in detail the essential elements of four of these carriers' grain marketing programs. The chapter that follows assesses the impacts of contract disclosure on each of these programs.

4.2 BURLINGTON NORTHERN COMMERCIAL STRATEGY DEVELOPMENT

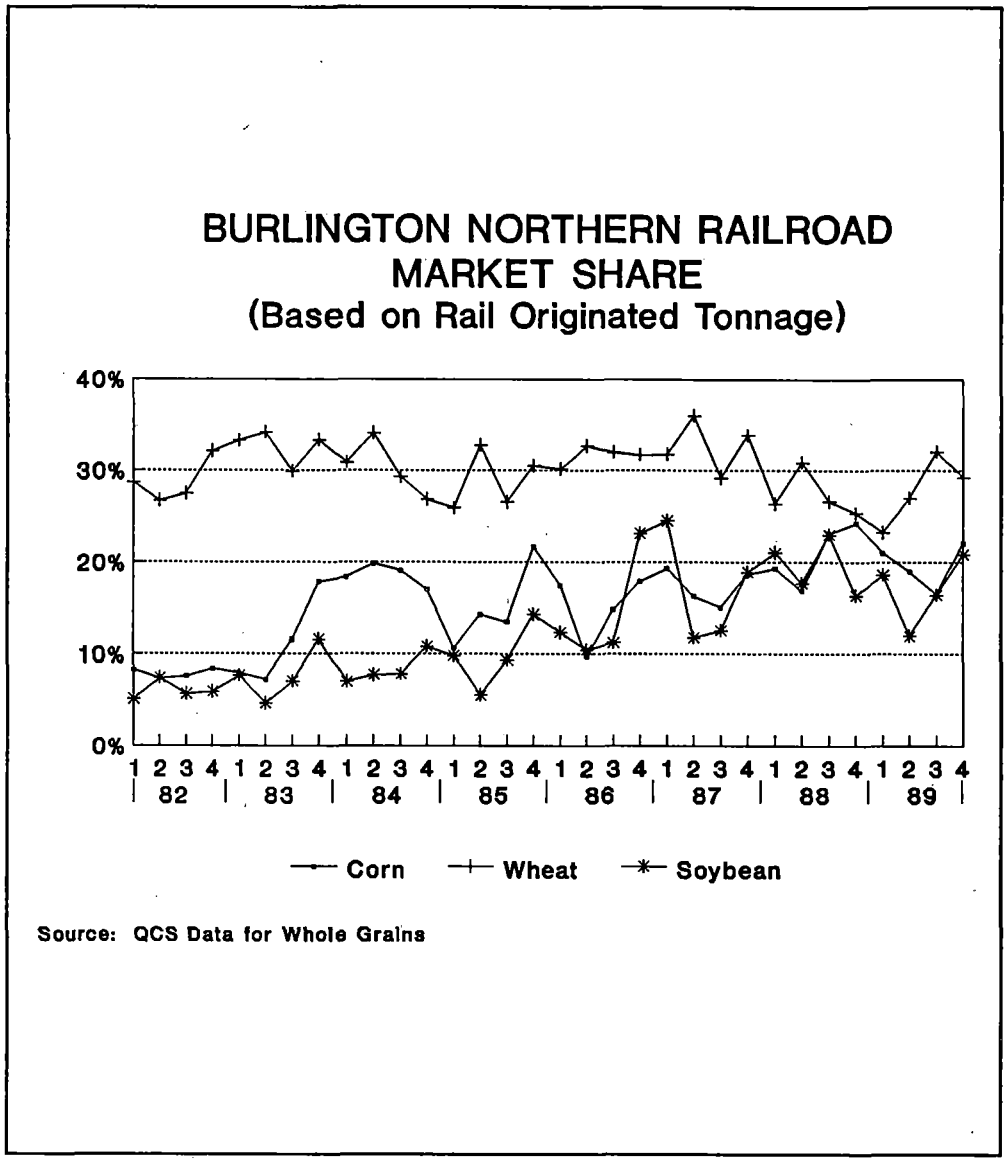
In the 1980's, the Burlington Northern has made greater gains in market share than any other major grain hauling railroad, primarily in the soybean and corn markets. The BN currently handles 28% of rail-originated wheat tonnage, 22% of originated corn, and 20% of originated soybeans. The BN's share of these latter two markets increased by ten percentage points or more during the later half of this decade (Figure 4.2).

FIGURE 4.1

GRAIN MARKETING PROFILES OF MAJOR GRAIN HANDLING RAILROADS

	Principal Customer Focus	Strategic Role of Contracts	Principal Market Segments
BN	Receiver Shipper Middlemen	None	Corn, Spring Wheat, Winter Wheat, Soybeans
UP	Receiver	Opportunistic; Respond to Specific Customer Requirements with Tailored Contracts	N/A
ATSF	Receiver	Opportunistic; Respond to Specific Customer Requirements with Tailored Contracts	Export Wheat, Domestic Wheat, Export Coarse Grains, Domestic Coarse Grains
CSX	Receiver	Fundamental Basis for Commercial Program; Specific types of contracts apply to specific market types	Export, Domestic Receivers
CR	Receiver	Export Grain Competitively Served Forward Mills	Domestic Processors, Export, Competitively Served Processors
NS	Receiver	Fundamental Basis for Commercial Program; Specific types of contracts apply to specific market types	Export, Domestic Receivers
C&NW	Receiver	Fundamental, Lock-In Base, Traffic	Large Volume Off-line Receivers
SOO	Shipper	None	Country Elevator Operators, On-line Processors, Off-line Processors
IC	Receiver	Fundamental Basis for Commercial Program	Domestic Poultry Feed Lots, Domestic Processors, Export Rail\Direct, Export Rail\Barge

Figure 4.2



Source: QCS Data for Whole Grains

4.2.1 BASELINE MARKET STRATEGY

The Burlington Northern (BN) is the largest grain carrying railroad in the nation, and perhaps the most innovative in its marketing program. It serves more than 1800 country elevators in 22 states and handles large volumes of corn originating principally in Nebraska, Minnesota, and Iowa; large volumes of spring wheat originating in Minnesota, Montana, and North Dakota, and winter wheat originating in Oklahoma, Nebraska, and Texas. The Burlington Northern

also handles large volumes of soybeans that originate in Minnesota, South Dakota, and Iowa. The Burlington Northern handles export grain, via both the Gulf Coast and the Pacific Northwest, and serves 15 major export grain elevators in various ports.

The objectives of Burlington Northern's marketing strategy include the following: 1) improve the efficiency and flexibility of grain markets the Burlington Northern serves; 2) improve rail operating efficiency and rail car utilization; and 3) establish a more effective logistics partnership between grain shippers and railroads.

The Burlington Northern competes in Western grain markets principally against the Union Pacific and the ATSF. Both of these competing railroads have unique markets and compete with the Burlington Northern primarily in somewhat circumscribed markets. The ATSF, for example, has an extremely strong position in the hard red winter wheat market, and in Gulf export grain markets, but not in Pacific Northwest export markets.

4.2.2 CHANGES IN MARKETING PRACTICE SINCE THE STAGGERS ACT

The Burlington Northern participated aggressively in contracting for grain services soon after the Staggers Act became effective. This parallels the experience of most other Class I carriers. In the soft grain market of 1981 to 1986, the Burlington Northern priced its contract services aggressively in order to realize market share growth. It attempted to use contracts to lock-in shipper commitments. This period was marked on the Burlington Northern by surplus equipment and strong downward pressure on rail rates.

As mentioned in Chapter 3, the BN introduced a unique mechanism for administering its grain service prices, called a Certificate of Transportation (COT). BN believes that COT's address a number of market problems inherent in BN-served markets, allowing the railroad to capture a larger share of value when grain markets are tight and grain prices high.[21] The carrier also believes

[21] As we discussed in chapter 2, BN's market share has increased significantly between 1982 and 1989 in corn and in soybeans. Its wheat market share has remained approximately constant.

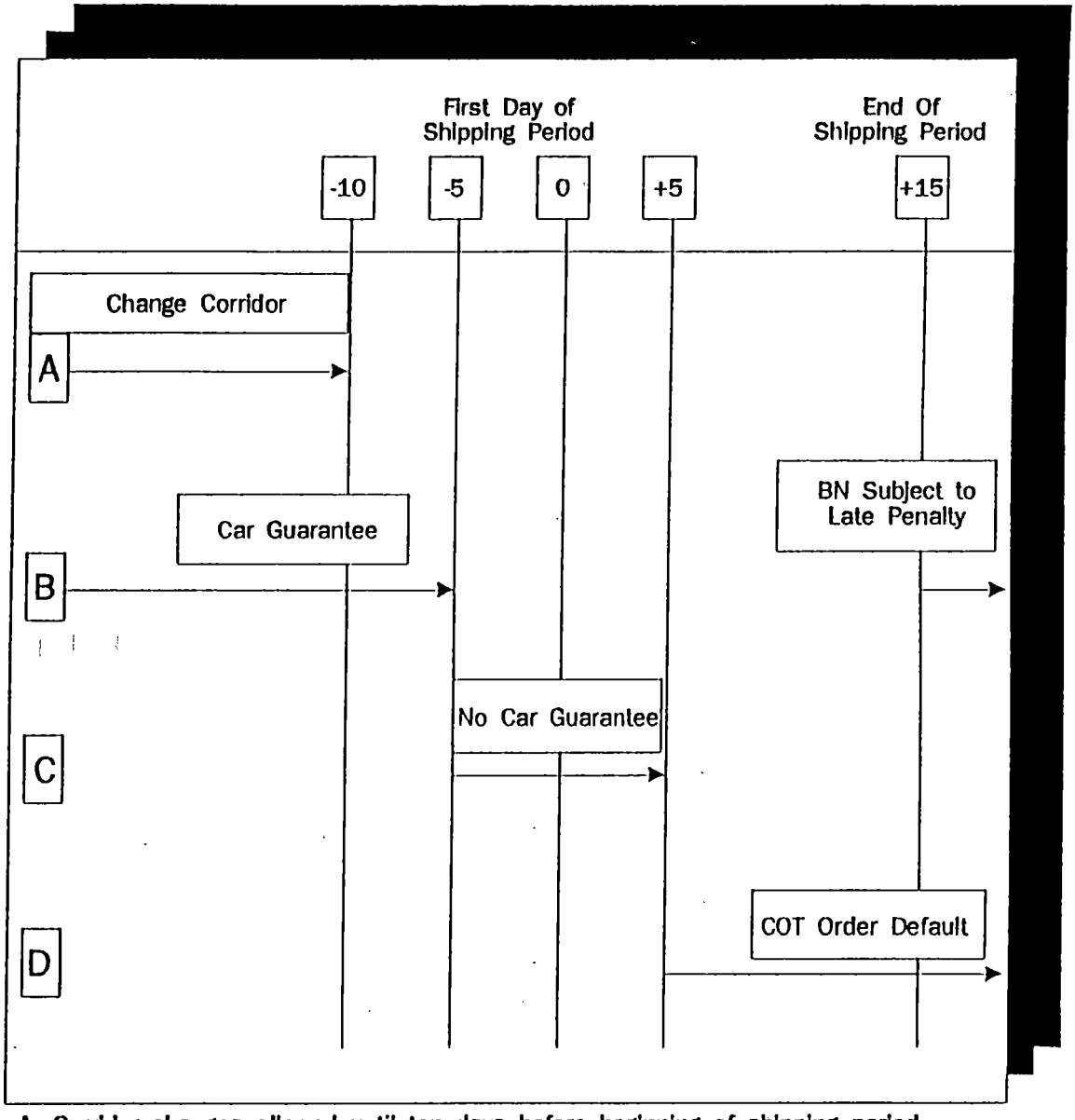
that COT's provide an efficient way to allocate limited equipment supplies, and, perhaps most importantly, also allow for the efficient operation of underlying commodity markets. BN announced its COT program in January 1988 and has refined it several times since, in a series of periodic offering memoranda.

COT's are auctioned in public markets and the results of COT's sales are publicly disseminated. The results of COT's sales are published in a tariff format. COT's themselves are negotiable. Although they obligate COT's holders to ship minimum volumes of grain on a schedule specified in the COT's offering memorandum, they also allow flexibility in the selection of service lanes and timing of COT's applications. The program is intended to create a forward market for rail service agreements. However, to date no formal secondary market has emerged. The program allows shippers to purchase transportation commitments from the railroad up to six months in advance of service delivery, and BN has also experimented with COT's for services to be delivered one year in advance of sale. COT's have been sold both at a premium and a discount to published tariff levels. COT's commitments guarantee that specific numbers of grain cars will be made available at specific locations during a specific shipping period. They also guarantee prices for specific grain transportation services. Figure 4.3 outlines the timing of the various offering events and decision points that are incorporated into the COT program. As the figure suggests, BN allows shippers to change service corridors and to retain their car guarantees up until 10 days before a designated shipping period.

According to the railroad, the forward commitment aspect of the COT program offers benefits both to shippers and to the rail carrier. COT's allow the Burlington Northern to balance locomotive power and to pre-position unit train car sets more efficiently. Since COT's began, BN car utilization has improved markedly.

Figure 4.3

COT'S TIMELINE



A. Corridor changes allowed until ten days before beginning of shipping period.

B. If car order is placed on or before five days prior to the beginning of the shipping period cars are guaranteed. If cars are not delivered before the end of the shipping period, BN is subject to a late penalty.

C. If car order is placed after five days prior to the beginning of the shipping period, but before the fifth day of the shipping period, there is no car guarantee. Cars will be supplied as available.

D. If the car order has not been placed by the fifth day of the shipping period, the COT is considered in default.

Source: Burlington Northern submission in ICC Docket 40169: National Grain and Feed Association vs. Burlington Northern

Forward planning also allows for better utilization of line haul capacity.

BN has voluntarily limited the proportion of its covered hopper fleet offered through the COT program to 40% or less of its total fleet. The Burlington Northern offers a varying number of COT's as demand and market conditions warrant, up to the 40% ceiling. COT's for specific corridors and specific commodities are offered on the same day each week. Bids are accepted for COT's via the telephone in a minimum price auction.[22] Successful bidders make an initial prepayment of approximately 25% of the total bid price. The remaining amount due is payable on or before the car order deadline for exercise of the COT. COT's are tradeable and assignable. Each COT represents the negotiation for a tariff rate and the Burlington Northern publishes a tariff which corresponds to each COT that it auctions.

4.2.3 CURRENT CONTRACTING POLICY

The COT program has continued to evolve since its introduction. In general, it has become more flexible and more expansive in its application. New corridors and new commodities have been added to the program and additional flexibility has been granted customers who buy COT's. Figure 4.4 describes the evolving aspects of the program.

COT transactions are confirmed in a tariff, not in a contract format. All BN whole grain traffic moves under tariffs. The carrier's contracting activity is limited to milled grain products.

The COT program appears to have enabled BN to avoid artificial segmentation and differential pricing among classes of potential customers, receivers, shippers or brokers. COT's are available to all classes of customer and their negotiable, tradeable format invites the participation of risk arbitragers. COT's allow public and equal treatment among all potential

[22] In a minimum price auction the seller offers a prescribed number of service units (e.g. unit trains) and accepts the highest prices offered for this number of units. Bids falling below the bid price of the last service unit offered are rejected.

Figure 4.4

CHANGES IN THE COT's PROGRAM SINCE ITS INCEPTION

FEATURE	ORIGINAL PROGRAM	SPRING 1990 PROGRAM
COMMODITY	Corn, sorghum, soybeans only	Adds barley and wheat, to include all major whole grain and oil seeds
CORRIDORS	East - West	All major grain corridors
SHIPMENT SIZE	54-Car Units	Corn, sorghum, soybeans: 54 cars and singles Wheat: 26 cars and singles Barley: 26 cars and singles
PREPAYMENT	Advance payment of full COT's price	25% of COT's price, prepayment with balance due at time of car order
INTEREST ON PREPAYMENT	90-Day, T-bill rate	Commercial interest rate as published in *Wall Street Journal*
PUBLICATION MEDIA	*Commodity News Service* and PC-compatible bulletin board	*Commodity News Service*, Bonneville Telecommunications, and PC compatible bulletin board
MINIMUM BID	Tariff level	Below tariff, depending on market
ROUTING FLEXIBILITY	None	Change corridor 10 days prior to shipment period for a fee
INTERLINE COMBINATIONS	Single factor combinations with commercial affiliated short lines	Combinations either with joint line contracts or tariffs

customers, although as a practical matter most COT's are purchased by receivers. COT's are an alternative to confidential contracts, but they are similar to contracts in that they offer a mechanism for locking-in rates for an extended term and for guaranteeing car supply. COT's, however, allow prices to be determined in competitive markets, not in one-on-one negotiations in which competitive information is not always available to both buyers and sellers.

The Burlington Northern's program has added liquidity to the transportation market and introduced the possibility of risk arbitrage.

The BN has also implemented a unique commercial policy regarding covered hopper car equipment. Burlington Northern allows no shipper-controlled equipment, as opposed to shipper-owned private equipment, to

operate on its line. BN does, however, allow private cars to operate under OT-5 occasionally when it is unable to furnish the cars, and in cases where the equipment has already been grandfathered under OT-5.[23] The railroad believes that the high levels of car use efficiency the carrier has been able to realize in recent years are closely tied to the unconstrained flexibility it enjoys in mixing and matching car sets without concern for ownership. In order to expand its carrier-controlled fleet to meet peak seasonal requirements, the Burlington Northern conducts an auction for private equipment several times a year. At these auctions, the carrier offers short-term leases to private car owners who are willing to release their equipment to the BN.

4.2.4 FUTURE TRENDS

BN will continue to modify its COT's program so that it better fits the requirements of grain market makers. In the near future, BN plans to expand the program into additional commodities; however, any future expansion of COTs will depend upon the outcome of the challenges to the existing program before the Interstate Commerce Commission.

4.3 CSX TRANSPORTATION

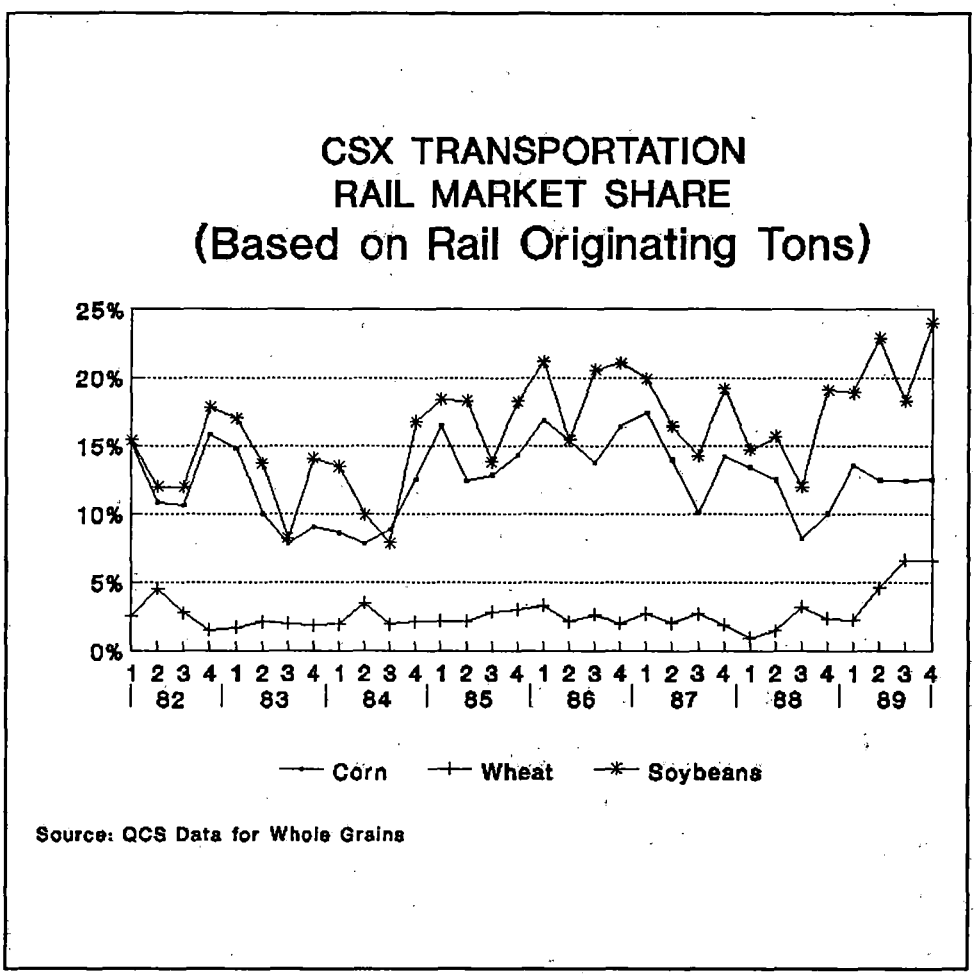
In the 1980's, CSX has been notably successful in increasing its participation in the soybean market, where it has developed a 21% market share. CSX ranks as the premier carrier in the soybeans market. Its share of the wheat market has also increased notably in recent years, albeit from a low base. Only its share of the corn market has declined marginally in 1988/1989 to 12%. Figure 4.5 illustrates these trends.

4.3.1 BASELINE MARKET STRATEGY

The principal markets CSX serves are domestic feed producing markets

[23] Carriers accept private equipment for on line use in negotiations codified in an "OT-5" document, according to the terms set out by the Association of American Railroads and its Operations and Transportation Committee.

Figure 4.5



in the Southeast and grain producing regions in the Midwest. The railroad works actively with feed mills to build new on-line facilities and to expand existing facilities so that they can receive unit grain trains. Contracts provide the basis for these capacity expansion arrangements, as well as the basis for most of the transportation services CSX offers grain shippers. Approximately 90% of the total grain tonnage moving to grain processors and feed mill facilities on CSX moves under contract. This percentage does not vary significantly by type of grain, or by end market (i.e., domestic or export). CSX also uses contracts to handle spot movements and to reposition equipment. CSX has a strong contract orientation, and contracts play a fundamental role within its market strategy.

Today, CSX contracts almost exclusively with receivers.[23] It allows these receivers variable discounts from tariff levels (which serve as list prices) depending on the lot size of shipments and the receiver's annual volume commitment. Among contract movements, 30 to 40 percent involve full unit train movements, 50 to 60 percent involve 15-car unit movements and a relatively small portion (less than 10 percent) are 3-car-lots or single-car shipments. Typically, CSX requires minimum volume commitments from its contract holders. However, it rarely makes equipment guarantees.

Although origin elevators initially resisted the CSX policy of contracting only with receivers, the fact clearly emerged, after CSX implemented the policy, that as CSX-served receivers expanded, CSX-served origin elevators have sold more grain. This has helped assuage the initial marketplace resistance. As a matter of policy, CSX notifies origin elevator operators each quarter of contract holders to whom they can sell grain. In addition, CSX sponsors an annual "linkage" meeting where CSX brings together mid-level grain marketers and purchasing agents. These meetings have proven quite successful.

CSX's grain marketing strategy is to foster grain traffic growth by pulling incremental demand into CSX's grain consuming territory. Part of this strategy involves incentives and programs to expand existing on-line, grain feed processors and other grain processors. Part of it involves the siting of new processing plants. CSX also uses contracts as a way to reduce both seasonality and cyclicality, and to smooth out demand for rail services. In recent years, CSX has attempted to renew contracts at higher rates to improve its overall revenue yield, although, typically, these rates remain below tariff levels. The current strategy has been in place for approximately five years. Recently, however, several basic elements in CSX's strategy are being reexamined by the carrier.

CSX's grain marketing program appears to have been notably successful over the last five years. The grain volume moving under contract has increased markedly during that period. CSX continues to seek increased car use

[23] Based on discussions with CSX marketing managers.

productivity through contracts. Like other carriers, CSX uses pricing incentives to increase the number of turns per car set and to spread export grain movements over multiple months, thereby reducing the cost of providing peak services.

CSX has focused its contracting efforts on the domestic, rather than the export, side of its business. The emphasis is designed to improve the grain handling capacity and efficiency of major domestic receivers who are the principal users of CSX's covered hopper fleet. The carrier is attempting to convert all major receivers to multiple car operations. Traditionally, export markets have been served by unit trains. The carrier believes that only a marginal opportunity exists for additional productivity gains in this market.

CSX's grain strategy has helped the carrier to grow its market base, especially in Midwest corn shipments into the Southeast. The railroad's primary marketing thrust in recent years has been to grow domestic markets. Two external market factors, higher U.S. consumption of poultry and increased consumption of fructose corn syrup have given CSX markets a strong growth impetus.

CSX export markets have been highly volatile during the 1980's and have not provided a reliable base to build a core business. More and more, CSX is attempting to move export shipments under tariff rates, in order to increase yield.

4.3.2 CHANGES IN MARKETING PRACTICES SINCE THE STAGGERS ACT

Shortly after the passage of the Staggers Act, grain contracting mushroomed. Indeed, contract grain activity increased rapidly on CSX until 1985/1986 (Figure 3.3). During this period, shippers rushed to contract for all of their moves. After growing for several years, contracting has now begun to decline. In fact, over the past three years, CSX contracting has declined steadily. This decline marks the increased sophistication of both shippers and carrier. It also marks the refinement and shift in the carrier's own marketing strategy.

4.3.3 CURRENT CONTRACTING POLICY

The typical terms and conditions involved in a CSX grain contract include a price fixed for the term of the contract, a volume commitment and a penalty for non-performance (Figure 4.7). CSX continues to insist on liquidated damage provisions in its contracts; i.e., shippers pay a penalty when they do not realize specific volume or revenue goals set in the contract. CSX typically makes no equipment or service guarantees in its contracts.

In most CSX contracts, the receiver pays the freight charges and it is the receiver who is the principal customer for CSX contract grain services. The factors that have shaped CSX's contract strategy include the franchise it serves in a large and rapidly growing consumption market. Processed grain for chicken feed experienced particularly rapid growth in the Southeast during the 1980's. The consumption of wheat, corn, and sorghum by Southeast-based processed feed and food producers represents a second important growth factor.

A major market objective that CSX has attempted to achieve through contracting is to induce the grain processing industry to expand, modernize or improve the efficiency of its grain receiving facilities. This strategy offers benefits both to the carrier and to its shippers. Long term contracts allow shipper management to predict future costs with confidence and finance plant expansion. Long term contracts also allow the carrier to plan its operations with certainty and to handle traffic more efficiently. An objective of increasing importance to CSX is gains realized through train scheduling and car management -- gains realized only through closer links with customers.

Most CSX contracts involve a refund, issued only after a shipper files a refund request confirming his compliance with contract requirements. The average elapsed time from actual movement to the filing date for a refund ranges between 3 and 6 months. The average time for receipt of the refund after filing is approximately 30 days.

Contracts for the transportation of export grain differ from those for domestic grain in that export grain moves principally in shipper-owned cars. Because export movements are marked by seasonal and cyclical peaks and valleys, CSX cannot provide sufficient equipment to handle peak export

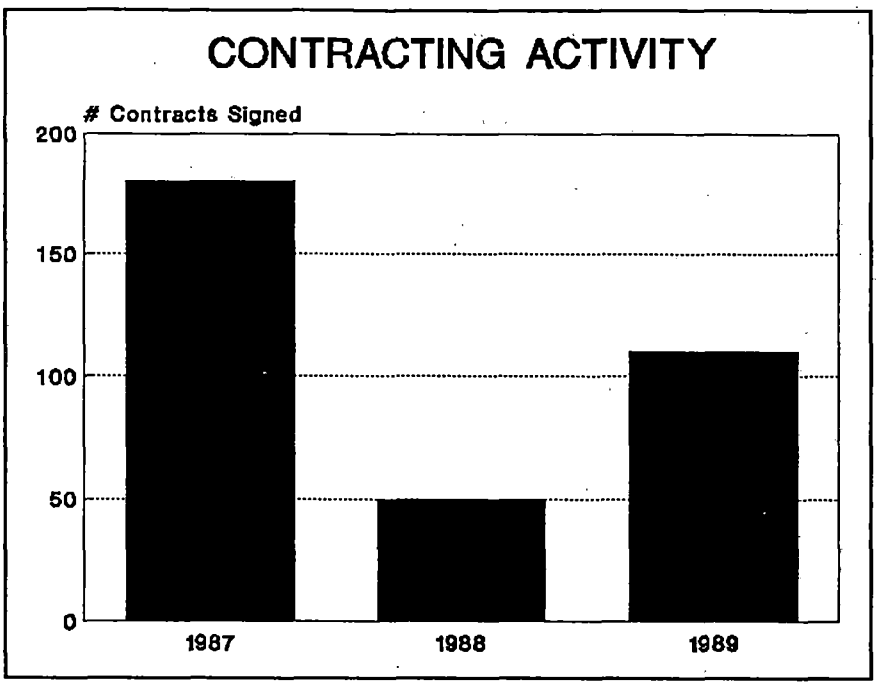
movements. CSX induces shipper use of private equipment through incentives provided both in contracts and in published tariffs.

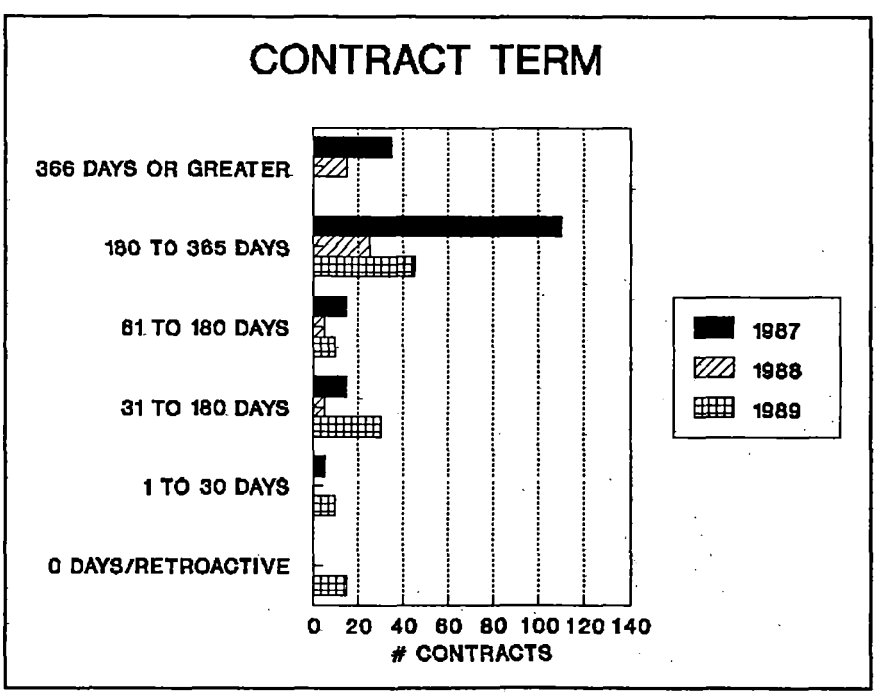
4.3.4 FUTURE TRENDS

If appears that little change, if any, will be made in current procedures in the near future. Contracts will continue to be used as the principal commercial mechanism in grain markets, although the trend towards greater use of tariffs is likely to grow in the 1990's. Contracts do not appear to have affected the allocation of equipment or the car ordering process at CSX. However, customers are increasingly looking for service and productivity stipulations in contracts. The carrier believes that guarantees concerning service and customer equipment utilization will begin to emerge in the near future.

Figure 4.6

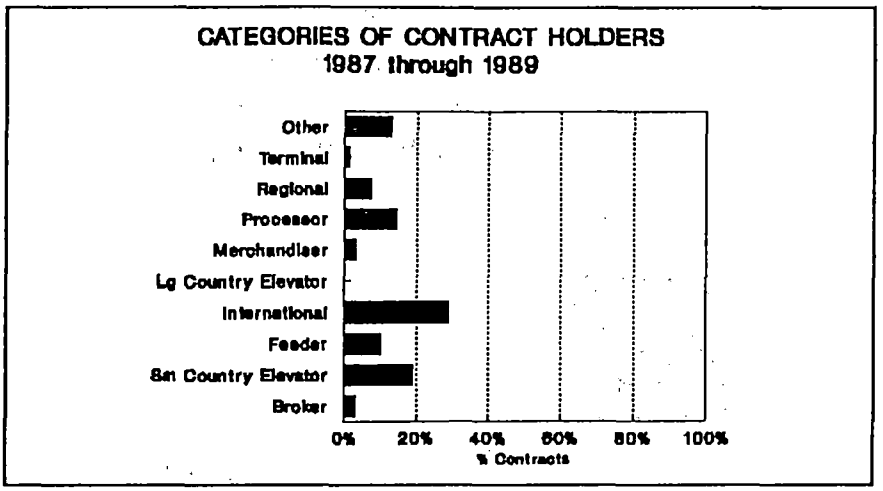
CSX TRANSPORTATION,INC.

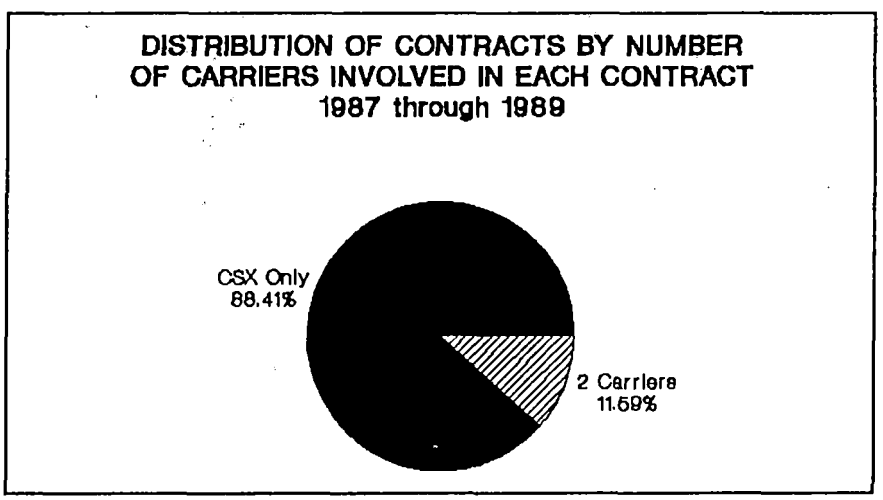


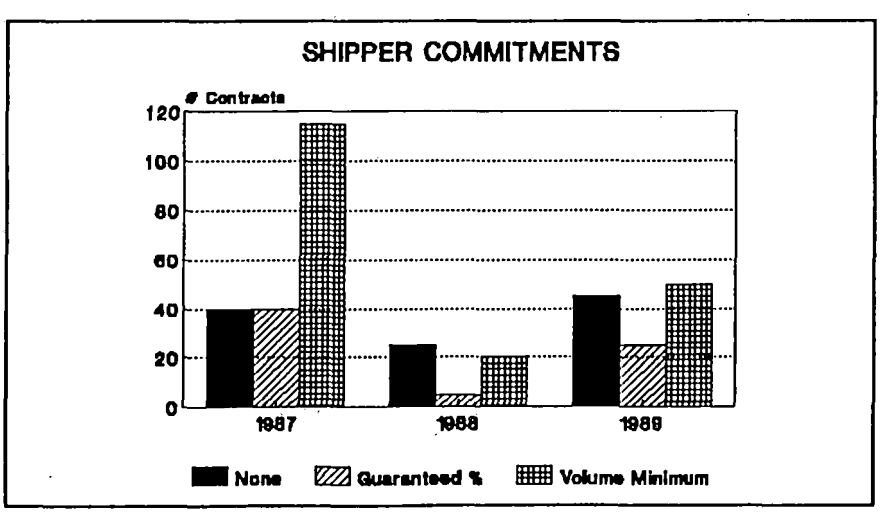


Source: ICC Grain Contract Summaries

Figure 4.7
CSX TRANSPORTATION, INC.





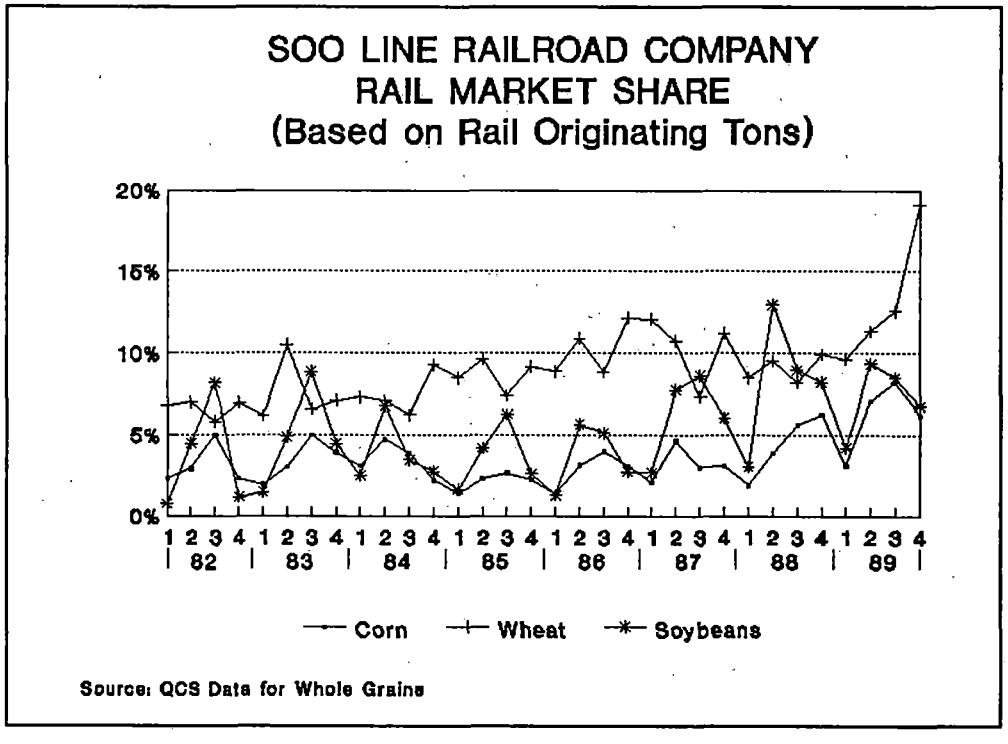


Source: ICC Grain Contract Summaries

4.4 SOO LINE COMMERCIAL STRATEGY DEVELOPMENT

As Figure 4.8 demonstrates, the Soo Line Railroad has made notable gains in market share during the 1980's. In wheat its market share for originated grain exceeded 15% in 1989, in corn its market share in 1989 exceeded 6%, and in soybeans, its share approached 7% in 1989. Although the carrier's shares of specific grain markets have been highly variable from year to year, the long term trend is clear: it has increased its market participation significantly in the late 1980's.

Figure 4.8



4.4.1 BASELINE MARKET STRATEGY

Most of the grain the Soo Line handles is local or interline forwarded traffic.[25] In order of importance, Soo Line originated grains include wheat and then corn; other grains are relatively insignificant individually, although in the aggregate, they do comprise a substantial volume of Soo Line's total grain

[25] Soo Line is a net generator of grain traffic. Its traffic includes large volumes of both local and interline forwarded traffic, but little interline received or overhead traffic.

movements. The objective implicit in the Soo Line's marketing strategy is to make its origin grain elevators competitive in as many markets as possible. The Soo Line serves approximately 400 country elevators in North Dakota, Northern Iowa, and Minnesota. It principally uses a tariff format to price its grain services to these elevator operators. Two sets of general application tariffs are operative, one for export and one for domestic movements. Contracts play a subordinate and auxiliary role in the railroad's overall market strategy.

The Soo Line attempts to compete on an equipment and service reliability basis with its much larger rail competitors. In recent years the Soo Line has augmented its own covered hopper fleet with additional leased equipment. It also actively manages the terms it offers shippers for the use of private equipment. The Soo Lone employs what one of its executives referred to as an "open OT-5 process." in order to accommodate volatile equipment requirements, the Soo Line moves mileage payments up an down, in line with changing covered hopper supply/demand conditions.

In 1987, the Soo Line redesigned its principal grain tariffs and transformed them into a more understandable and accessible document -- a "customer friendly" resource, as Soo Line's managers term the new tariff document. Since revising its tariff format, it has also participated in more dynamic pricing -- with more frequent price revisions. Soo Line revises and adjusts its tariff almost every week.

Country elevator operators in North Dakota, Northern Iowa, and Minnesota represent the principal customers whom the Soo Line attempts to serve with its current marketing program. A distinct aspect of the railroad's marketing program includes its strong "country elevator orientation." According to the Soo Line, the carrier maintains frequent communications with country elevator operators it serves through its extensive field sales network.

The railroad competes for originated grain with the Burlington Northern and the C&NW. It relies on the ATSF and BN, together with the IC, UP and SP to deliver its originated export grain to Gulf and Pacific Northwest export elevators.

4.4.2 CHANGES IN MARKETING PRACTICES SINCE THE STAGGERS ACT

The Soo Line made a major change in market orientation in 1987. Previous to this date the railroad pursued an aggressive contracting program. During this prior period, the Soo Line contracted with shippers, with receivers, and sometimes with grain middlemen. It competed aggressively on a discounted price basis for increased market share during a notably soft market. The period 1981 through 1986, however, witnessed a significant reduction in the revenue yield generated from contract grain traffic. In 1987, according to the carrier, the Soo Line reversed direction, dramatically reduced its grain contracting activity and implemented the current policy. That strategy appears to have worked. Soo Line-served elevators are healthy, the value of these elevators (reflected in recent sales) has increased, and Soo Line grain revenues have also increased.

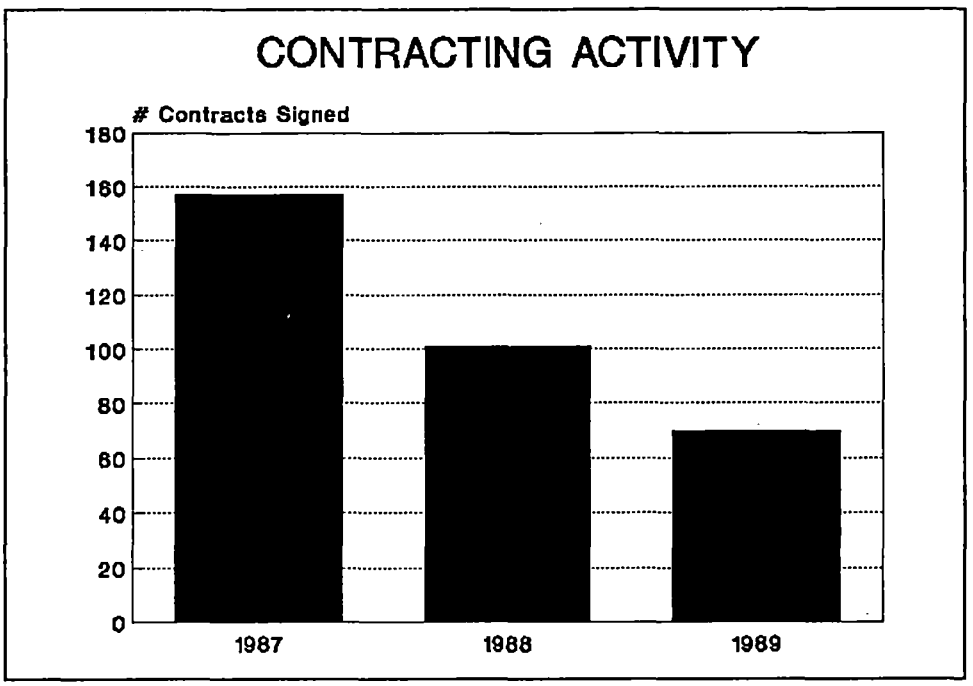
4.4.3 CURRENT CONTRACTING POLICY

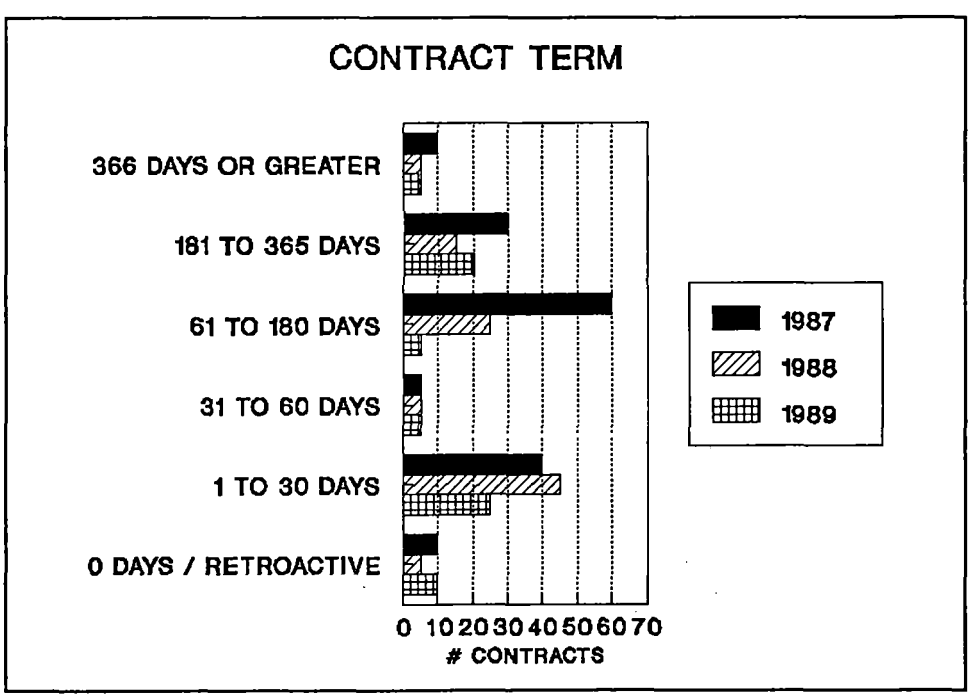
Soo Line currently moves only 10% of its total grain traffic under contract. Contracts are used to meet specific and limited tactical objectives. For example, most Soo contracts apply to movements in direct competition with the C&NW or Burlington Northern or from large terminal elevators that are open to switching. Contracts typically apply to competitive junctions. These circumstances have developed historically. In cases where shippers give the Soo Line the option either to participate in profitable movements under contract or not participate, it has elected in most cases to participate. Most frequently, Soo Line contracts have been written with off-line milling companies who source grain from terminal elevators in cities served by Soo, such as Minneapolis and Kansas City.

The Soo Line also uses contracts to adjust or amend tariff applications. For example, under special circumstances it has used contracts to absorb switching charges, to induce accelerated payments and to provide service guarantees. Figures 4.9 and 4.10 provide a profile of contracts served by Soo Line.

Figure 4.9

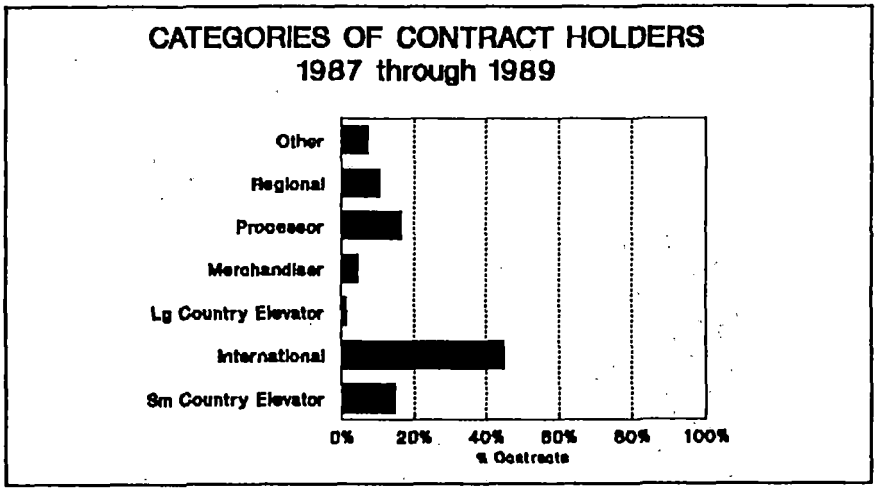
SOO LINE RAILROAD COMPANY

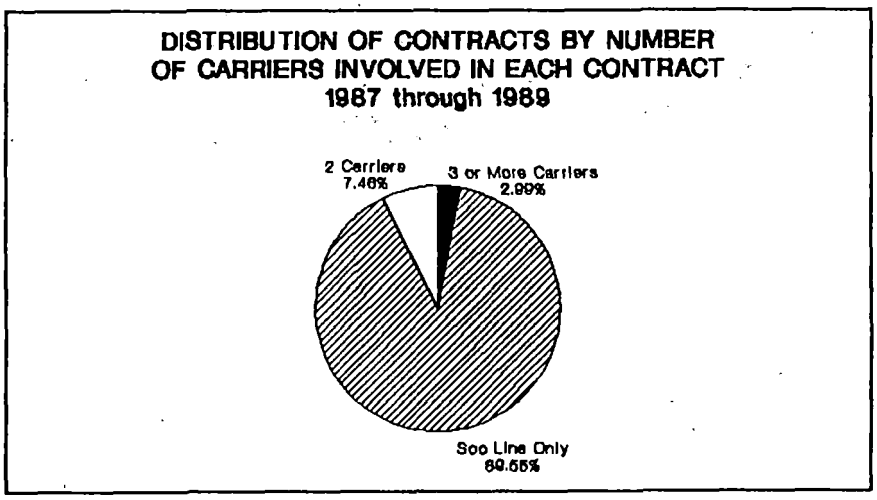


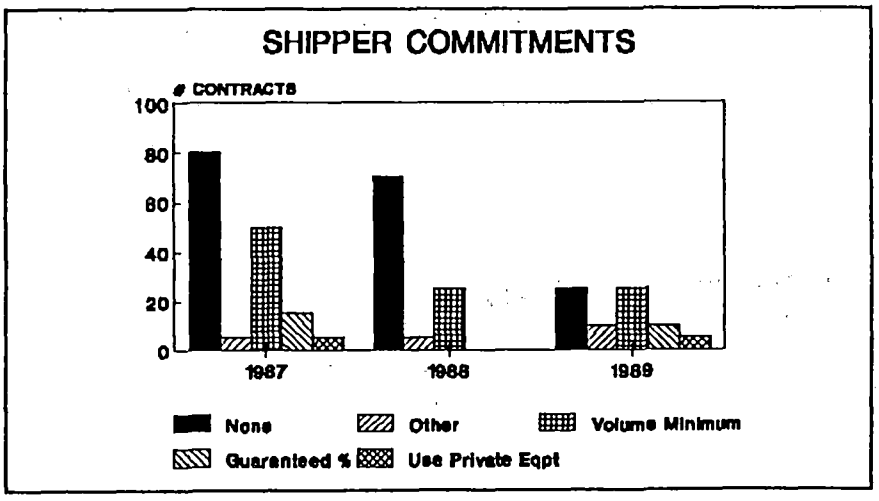


Source: ICC Grain Contract Summaries

Figure 4.10
SOO LINE RAILROAD COMPANY







Source: ICC Grain Contract Summaries

4.4.4 FUTURE TRENDS

No fundamental changes in Soo Line's commercial strategy are anticipated in the near future. Current policies will simply be fine-tuned. It expects the grain volume it handles under contract will continue to decrease. It will continue to focus on improved equipment utilization and still higher levels of service reliability via its principal grain corridors.

The Soo Line believes that all of the terms and conditions included in contracts can be included, as well, in tariff publications. It believes that the only benefit of contracts is their more rapid implementation. Indeed, contracts can be implemented retroactively. The carrier believes that in every other respect "customer friendly" tariffs provide a superior medium for codifying commercial agreements.

4.5 CONRAIL COMMERCIAL STRATEGY DEVELOPMENT

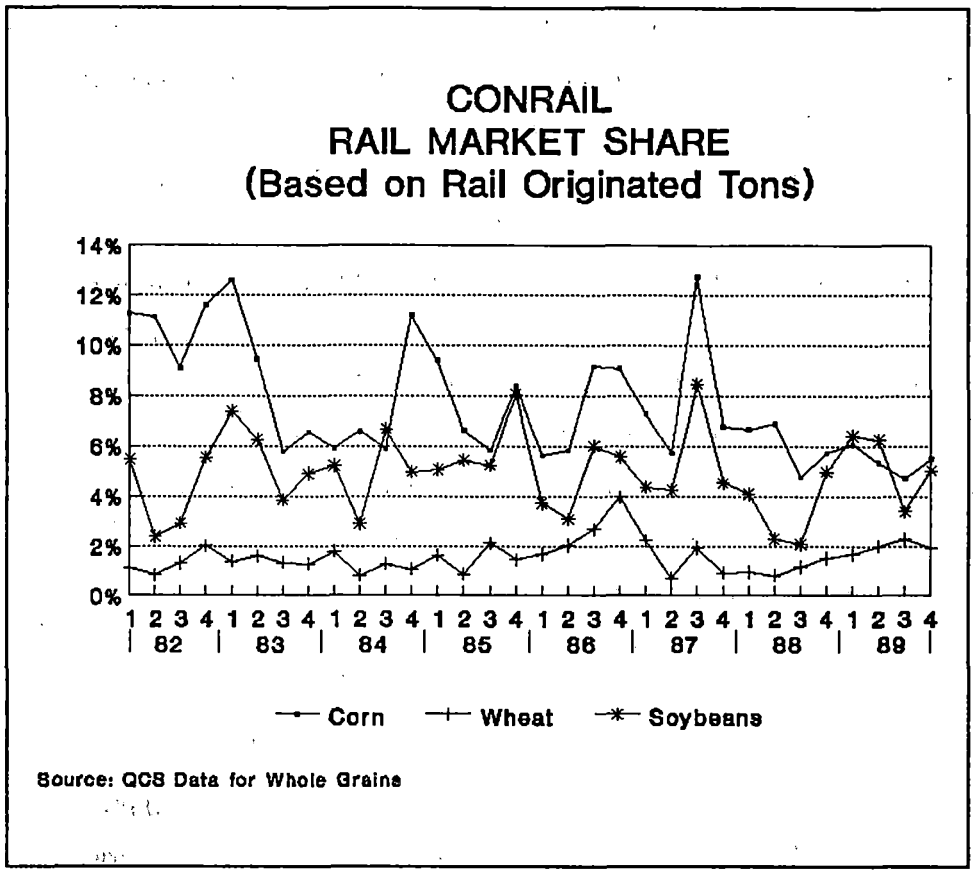
As Figure 4.11 demonstrates, Conrail's share of the originated corn market has declined progressively to less than 6% during the 1980's. Soybean market share bounced back in 1989 after falling steadily earlier in the decade. Current share exceeds 4%. Originated wheat share is about 2%.

4.5.1 BASELINE MARKET STRATEGY

Conrail is principally a grain terminating railroad. The domestic grain processing markets it serves are mature. These markets offer Conrail limited opportunity for volume growth. As a result, Conrail's grain marketing strategy reflects a strong receiver orientation. Conrail has attempted through its marketing programs to optimize its gross revenues on inbound grain traffic -- traffic that satisfies the net supply deficit of the large consumer market it serves.

The grain embargo of 1979 severely impaired North Atlantic export activity -- particularly activity in Conrail's service territory. Since then, Conrail's export grain volume has declined to a historically low level and currently

Figure 4.11



represents only 20% of its total grain volume. Since the Staggers Act, Conrail has been reluctant to invest in the covered hopper equipment necessary to serve the volatile export market and has instead attempted to induce shippers to use their own private equipment for export movements.

Conrail has maintained continuity in its grain marketing strategy since the implementation of the Staggers Act. Its objectives in 1990 remain essentially the same as those it established in 1981: 1) to maximize volume participation and profitability in grains delivered within Conrail's service territory; 2) to maintain even-handed competition among grain producers outside Conrail's principal consumption areas; 3) to maintain market share by providing more attractive rates for private equipment.

The competitive environment in which Conrail operates is favorable to its market share maintenance strategy. North Atlantic water carrier rates for

grain are only marginally competitive with Gulf Coast rates. Hence, the upside potential for East Coast grain exports is limited to periods of peak market activity. Conrail competes primarily on a domestic, demand pull basis. Many of the mills and processing centers it serves are local stations on Conrail. Competition in this market is mainly from CSX, D&H and trucks.

4.5.2 CHANGES IN MARKETING PRACTICES SINCE THE STAGGERS ACT

The current Conrail marketing strategy has not changed materially since its inauguration ten years ago. Conrail believes that it distinguishes itself from its rail competitors principally in the quality of its service -- its superior transit time and superior service reliability. Shippers agree that Conrail offers excellent service.

In order to induce customer use of private covered hopper equipment, Conrail has continued to increase the price spread separating rail and private equipment. This price spread typically applies both in tariff and contract formats.

Service contracts play a limited role in Conrail's marketing plan. Overall, contracts account for 25 to 30% of its total grain movements. Most Conrail domestic grain moves on tariff applications. In addition, since October of 1990, most soybean meal moves on tariffs. Conrail tariffs have been refined to point-to-point applications. Conrail's new grain tariff is scheduled to become effective on October 17, 1991.

Domestic movements to New England destinations principally move under contract -- particularly movements that are directly competitive with Canadian routes. In addition, 100% of Conrail's export grain moves under contract.

4.5.3 CURRENT CONTRACTING POLICY

Conrail contracts to attract grain that would not otherwise move via its railroad. As we noted above, this includes principally export grain, and less frequently, domestic grain moving to competitively served forward mills. Conrail contracts include provisions that have become standardized over time.

These standard provisions include the following: 1) terms usually good for 1 year or less (October through September terms typically apply in export grain contracts); 2) rates proportional to reference tariff rate levels; 3) all rates set on a per car basis; 4) few shipper volume commitments; 5) multiple car (15 unit) tender requirements almost always apply. Figures 4.12 and 4.13 provide a profile of contracts signed by Conrail.

Conrail has pursued no operating or efficiency improvement objectives through contracting. Most of the forward mills and export elevators it serves in the East already have multiple car holding capacity. However, Conrail has attempted to gradually rachet up the minimum private car tender that qualifies shippers for price discounts. Currently, 15 car lots are the standard minimum tender. No discounts are currently allowed in railroad equipment. Instead, Conrail has encouraged efficient multi-car operations through separate sidetrack investment incentive agreements.

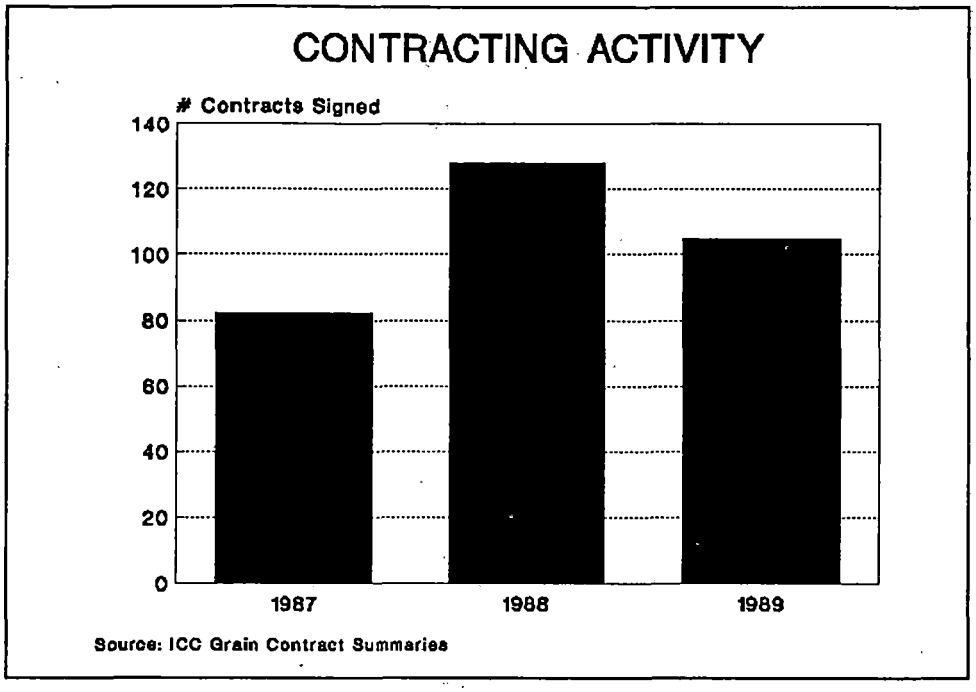
4.5.4 FUTURE TRENDS

Contracting activity under the Staggers Act grew from a zero base to a peak level in 1986 and 1987. This explosive growth strained the management and contract oversight resources of the carrier. The contract management resources of large shippers were similarly strained. The carrier believes that contracts require more manpower to negotiate and to administer than do tariff publications. Conrail believes that, as a rule of thumb, on 15% of grain movements should move under contract. This corresponds to a level of management resources that the carrier can afford to dedicate to contract administration.

The content and format of grain contracts has changed on Conrail and will continue to evolve. The goal here is simplicity: simplicity in interpretation, simplicity in application, and simplicity in computer based contract management.

Figure 4.12

CONRAIL



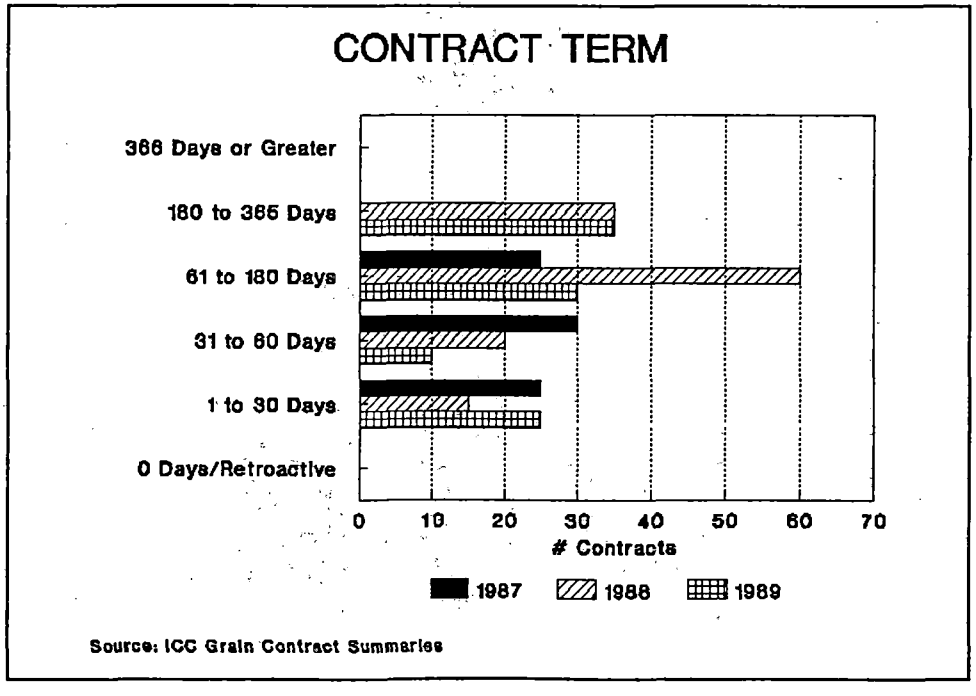
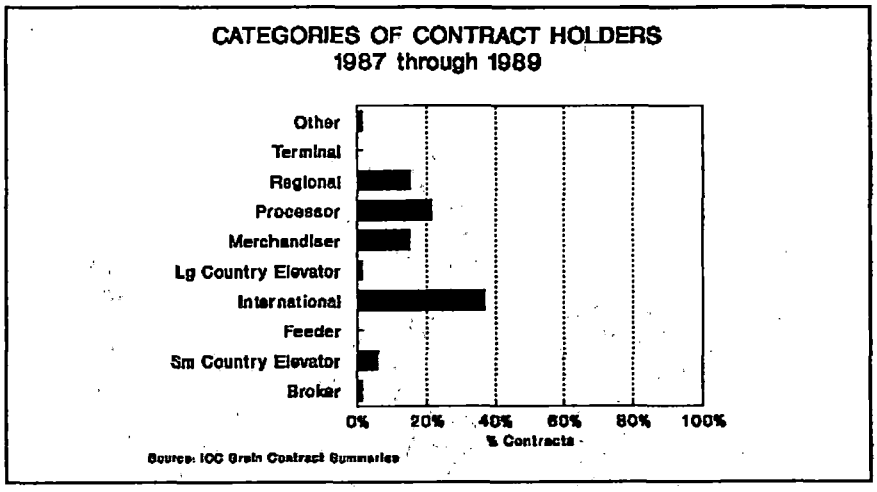
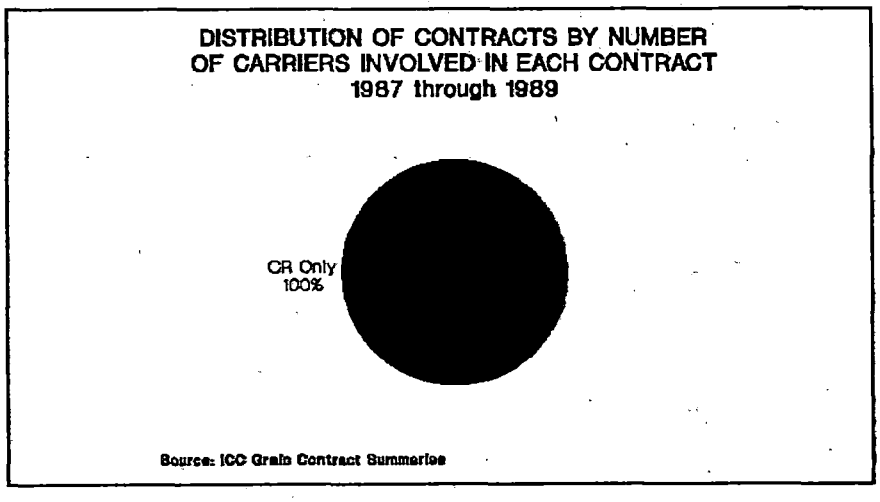
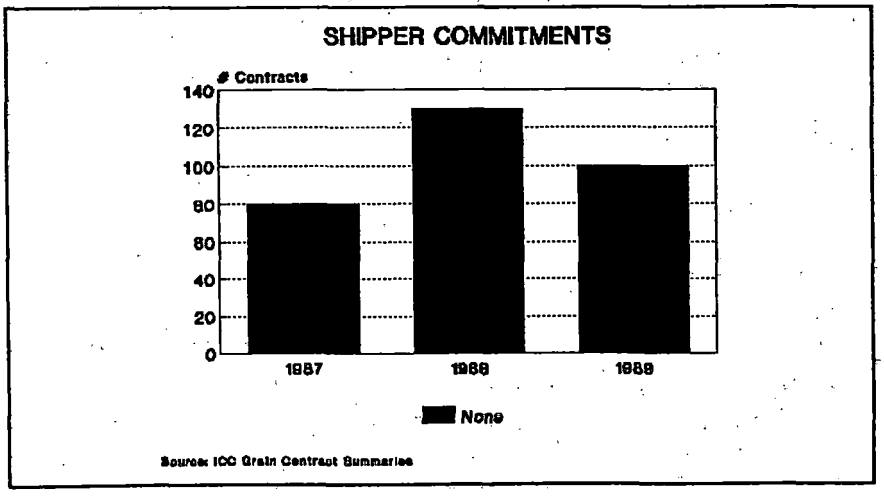


Figure 4.13

CONRAIL







5.0 EFFECTS OF CONTRACT DISCLOSURE ON SPECIFIC CARRIERS

The principal effect of contract disclosure has been in shaping the commercial strategy of individual carriers. As we discussed in the previous chapter, commercial paradigm development in the post-Staggers era has been principally characterized by its diversity and originality of response to unique markets. As we will discuss in this chapter, the effects and influences of contract disclosure on the four carriers whose strategies were reviewed in Chapter 4, have been no less diverse than the original commercial experimentation that followed deregulation. The impact of contract disclosure on other grain hauling carriers is discussed in the appendix.

In the context of contract disclosure, the key issue arises: Would the development of grain contract services be essentially different without disclosure requirements? In this chapter we attempt to answer this question and related ones. No clear consensus appears to exist, even today, among carriers on the subject of contract disclosure. Although a majority of railroads appear still to oppose liberal disclosure in principal, even that opinion is not shared universally among railroads. Indeed, opposition to disclosure among the majority of railroads appears to be based more on philosophical or ideological grounds than on specific effects or particular adverse consequences that have resulted from contract disclosure. Even this generalization, however, overstates the unanimity of opinion on and commercial accommodation to disclosure.

5.1 BURLINGTON NORTHERN ON CONTRACT DISCLOSURE

Effects of Disclosure. The Burlington Northern makes information on successful COTs bids publicly available, including information on car volumes, prices, commodities and corridors, but it does not identify COTs holders. This information may perhaps have more economic relevance than the information that the Commission requires in primary contract disclosure.

The Burlington Northern's position is that confidential grain contracts tend to distort underlying markets and force grain to move in corridors or to end markets that may not be the most efficient, from a total distribution perspective. This distortion is more a problem with conventional contracting

practices than it is with disclosure requirements *per se*.

With regard to contract disclosure, the Burlington Northern tends to take the position that if shippers and receivers want it, it must have some value. The railroad would therefore prefer to retain the current disclosure policies.

Changes in Disclosure Requirements. Burlington Northern did not recommend any specific changes in contract disclosure rules. It believes that since disclosure appears to give security to small grain shippers, it should be retained as it currently stands.

5.2 CSX ON CONTRACT DISCLOSURE

Effects of Disclosure. CSX reports that disclosure has had little effect on its contracting practices. Disclosure has resulted in no change in the willingness of either shippers or the railroad to enter into contracts, nor has it resulted in any change in volume of traffic moving under contract.

CSX monitors contract grain summaries on a regular basis. However, it feels that this source of market information is not as valuable as other informal sources. Market managers typically find out substantially more about market developments by talking to people who are involved in the business. The costs of administrative compliance with disclosure requirements, however, are quite stiff. Filing frequently requires couriers to deliver contracts to the ICC, and additional record-keeping by the carrier. CSX believes that the cost of disclosure exceeds any benefits which have been derived from it.

Changes in Disclosure Requirements. The carrier's principal complaint with disclosure compliance involves the high administrative costs involved in report compliance. CSX would like to eliminate most of the reporting requirements that go with contract disclosure. From CSX's perspective, disclosure has increased costs without generating commensurate benefits.

CSX has recently adopted a conscious policy to write fewer contracts, and to switch movements that were formally handled under contract to tariffs, wherever that is possible. The carrier believes that tariffs offer several benefits. Tariffs are simpler. In the case of larger shippers, tariffs entail less disclosure of the shipper's position. However, one of the features about a

contract that continues to make it attractive is its immediate effective date. Actually this is more a disadvantage associated with current tariffs than a benefit associated exclusively with contracts. CSX believes that steps should be taken to streamline tariff filing procedures.

5.3 THE SOO LINE ON CONTRACT DISCLOSURE

Effects of Disclosure. The Soo Line has had one informal request from a shipper that he be granted a contract with terms identical to those the Soo Line had allowed another shipper. That was in 1987. However, Soo Line feels that contract disclosure has had little, if any effect, on the evolution of its commercial strategy.

Since the Soo Line relies so little on contracts, it is neutral with regard to most contract disclosure issues. However, Soo Line believes that a clear potential exists for disclosure abuse, particularly with regard to secondary contract disclosure. Secondary disclosure gives a disgruntled shipper a potent weapon to use against carriers whose contracting policies he does not like.

Changes in Disclosure Requirements. Soo felt that primary contract disclosure requires more exacting information than necessary to comply with the intent of Congress to protect non-participants. For example, origin/destination specifications in contract disclosure summaries sometimes exceed the location detail found in the original contracts to which these summaries correspond. It would also like other changes, including: 1) Grain commodities need to be specified in less detail; 2) Transit points and shipper facility locations do not need to be detailed at all since this information is of little value; and 3) Car limitation representations (compliances with the 40% rule) are meaningless and, in any case, impossible to monitor.

5.4 CONRAIL ON CONTRACT DISCLOSURE

Effects of Disclosure Requirements. No shipper has requested, either informally or formally through the ICC's disclosure process, that it be granted the same terms as those contained in a Conrail contract negotiated with another shipper. However, the threat of contract disclosure has had a

formative effect on Conrail's commercial strategy. That threat has discouraged the carrier from using contracts more extensively and has influenced Conrail to rely principally on point-to-point tariffs to codify its commercial terms. Prior to the threat of contract disclosure, Conrail used a different tariff pricing system, one which used a basis point structure for determining freight charges. Contract disclosure has directly influenced Conrail to develop an intricate and refined point-to-point pricing structure that might have been more effectively handled in a contract format.

Conrail's view is that the costs of contract disclosure exceed any potential benefits. Still, contract disclosure requirements have caused no insurmountable difficulties for Conrail. Its commercial strategy, based on equitable shipper treatment, would be essentially the same whether or not a tariff or contract format were used. The carrier opposes disclosure because of its unnecessary administrative burden.

Changes in Disclosure. Conrail believes that, short of complete elimination, several changes could be made in primary contract disclosure. These include eliminating the disclosure of shipper identity and the car use limitation declaration. These are meaningless and in many cases impossible to monitor. In addition, Conrail would also like to eliminate minimum and actual volume commitment and eliminate acknowledgment of an escalation provision. These disclosure requirements are either redundant, meaningless or a violation of essential contract confidentiality.

5.5 GENERAL CONCLUSIONS

Although a clear diversity of opinion still exists within the rail industry regarding contract disclosure ten years after the passage of the Staggers Act, we can draw some general conclusions about the effects of disclosure based on both the actions and stated opinions of the carriers.

The broad grounds for redress provided to agricultural shippers in the Staggers Act, combined with contract disclosure, gave shippers in the period additional leverage in contract negotiations with rail carriers. Moreover, the threat of disclosure litigation influenced many carriers to formalize and articulate

their marketing programs, in order to reduce any confusion or suspicion on the part of shippers concerning their actions. The results of disclosure in the post-Staggers era were fourfold:

- ***Downward Price Pressure*** - Several carriers noted that the threat of disclosure allowed shipper contract negotiators to exercise additional leverage in negotiating lower rate levels. Contract rates tended to find a lowest common denominator in an environment in which contract data was broadly disseminated, in which grain markets remained soft, and in which excess car capacity continued to exist. However, the specific effects of contract disclosure are difficult to isolate from other factors which tended to push contract rate levels lower.

- ***Formalization of Marketing Programs*** - The ICC's final rules on contract disclosure tended to accelerate the process of marketing program formalization. Marketing programs that explicitly identified a threshold basis for contract holder qualifications and that further provided standard terms and conditions for contracts of specific types became the bulwark behind which individual carriers could defend their practices as non-discriminatory.

- ***Accelerated Movement toward Receiver Oriented Contracts*** - Receiver programs quickly came to dominate the rail industry. In part, this development resulted from the fact that receiver programs reduced risk exposure to charges by shippers of discriminatory pricing and shifted the burden of dealing with the shippers to the receivers. Most rail carriers discovered early in their experimentation with grain contracting that negotiating satisfactory contract terms among origin elevators is an impossible task. Moreover, most discovered at the same time that effective traffic control typically resided with the receiver, not the shipper.

- ***Reduced the Number of Outstanding Contracts*** - The result of contract disclosure has been a marked reduction in the number grain contracts. At the time the total number of rail contracts continued to increase in 1987 and 1988, the number of grain contracts fell off sharply. In part, this resulted as some roads moved away from contracts (e.g., Soo Line and BN). Also, it was the result of roads moving to receiver contracts which are typically larger and more encompassing.

Most carriers modified their commercial strategies in the period 1986 to 1988, at least in part to minimize contract disclosure liability. For example, most carriers formalized their contracting programs during this period and, in

formalizing their programs, established similar terms for all qualified contract participants. Many railroads have more recently begun to shift their pricing back to tariffs and away from contracts. Other carriers are closely monitoring the regulatory status of BN's COTs programs. The future of grain contracting may well evolve in the direction of COTs, which appear to more effectively link underlying grain market dynamics to rail service pricing than other pricing mechanisms currently being tested. During the period studied, only a few railroads, most notably CSX and C&NW, continued to use contracts to segment markets and to obtain volume commitments from large shippers.

Although no unanimity exists within the rail industry regarding the overall merit of continued contract disclosure requirements, carriers appeared to agree that specific modifications in contract disclosure requirements may be advisable. Figure 5.1 summarizes our interview results.

Figure 5.1

PRIMARY DISCLOSURE REQUIREMENTS:
ASSESSMENT OF RAIL INTERVIEWEES
(Percent of Interviews)

	Retain	Eliminate	Change
Specific Commodity	60%	30%	10%
Shipper Identification	50%	50%	0%
Origins & Destinations	40%	50%	10%
Contract Duration	70%	30%	0%
Rail Car Data	60%	40%	0%
40% Equipment Limit	20%	80%	0%
Minimum Volume	50%	50%	0%
Volume Breaks	20%	80%	0%
Base Rates	40%	60%	0%
Escalation Provision	40%	60%	0%
Special Features	22%	78%	0%

6.0 SHIPPER PERCEPTIONS OF CONTRACT DISCLOSURE

During this study we interviewed a cross section of grain shippers to determine their views on three subjects:

- *Contracting practices of rail carriers*
- *The disclosure process itself*
- *Impact of changes in rail disclosure rules*

Appendix B includes a description of the shippers we interviewed and explains the basis for their selection. With each shipper, we conducted an open ended interview to ascertain their perceptions on how the disclosure rules have influenced commercial policies of individual railroads since the Staggers Act. We also explored how disclosure has influenced railroad efficiency and the marketing of grain. In this context, a key issue is whether changes induced by contract disclosure are serving the purposes for which they were originally intended.

Most shippers with whom we spoke agree that contract disclosure, and contracting practices generally, have worked well since disclosure became fully effective. A period of testing and interpretation from 1986 through 1987 has been followed by a period of refinement in the protection contract disclosure affords grain shippers. Importantly, the period that has elapsed since the implementation of the Staggers Act has principally been a buyer's market -- characterized by falling rate levels and excess car supply. Only since 1987 have grain transportation markets tightened. During this extended "buyers" market, rail carriers have been more receptive to suggestions from shippers regarding the direction of their commercial strategy than might have been the case if markets had been "tighter." One result: the number of conflicts over disclosure have been minimal. In any case, most shippers appear to agree that contract disclosure and contracting practices of individual rail carriers have generally worked well.

Interviews with individual shippers lasted anywhere from two to five hours and covered numerous issues in depth. The following sections summarize the views that surfaced in these discussions. Although in many cases, these views expressed a strong majority agreement, and sometimes even

consensus, other issues surfaced where little agreement emerged among shippers about the effects and consequences of contract disclosure. In the aggregate, however, a majority of shippers appear to agree that contract disclosure has worked effectively to their benefit.

6.1 CONTRACTING PRACTICES

Criteria for carrier selection: The criteria that grain shippers principally use to select a rail carrier include the following:

- Price
- Service
- Car supply

Of these three, price is undoubtedly the most important and contract negotiations turn in large part on issues of price. A number of ancillary contract terms including switching charge absorption, car detention charges, and volume refunds relate closely to price.

Where private cars are used in specific services, the ability of a railroad to turn cars becomes a critical factor in carrier selection, second in importance only to price. However, carriers are extremely reluctant to make contract commitments guaranteeing equipment utilization. Still service quality, as measured by equipment turnaround times, is quantifiable and appears to vary significantly among individual rail carriers. One major grain shipper, for example, quoted the following statistics for car fleet utilization on major eastern railroads:

SERVICE QUALITY MEASURES

(No. of trips per month)

Railroad	Unit Trains	Single/Five Car Lots
Carrier A	4.0	1.5
Carrier B	3.0	1.2
Carrier C	1.5	0.8

According to this shipper, the service on Carrier A is measurably superior to service on other Eastern railroads. However, rates on the competing

properties are comparable to Carrier A's rates. Hence, this shipper tries to keep his private equipment on roads that can deliver superior car turnaround.

Car supply is also a key criteria in the selection of carriers. Shippers neither measure nor are concerned about how fast railroads turn their own cars. However, car supply and railcar availability is a critical issue, particularly during tight markets, in which shippers are dependent on railroads to supply equipment.

Rate spreads. Shippers appear to agree that contracting for rail transportation of grain has lowered rates and helped them save on transportation costs. In spite of the fact that limited evidence exists that productivity gains have resulted from contracting, in the 1980's, contract grain rates have fallen between 4 cents to 6 cents per bushel below tariff rates. In selected cases the rate spread has been as high as 8 cents per bushel. Significantly, the differential between tariff and contract rates for private equipment are somewhat higher (10 cents per bushel or more.) However, differentials for both private and railroad equipment have shrunk in the past two years as car supply has become more balanced with demand. In some cases, shippers -- particularly large volume shippers -- receive refunds in addition to lower contract rates. Though most shippers were unwilling to quantify the amount of these refunds, one large volume shipper did indicate that its rail contract refunds amounted to approximately 2 cents per bushel.

Rail Contracting Practices. The shippers we interviewed observed a wide divergence in the contracting philosophy and practices of individual rail carriers. At one extreme they identified railroads who are still seeking market share and volume increases. These roads are eager to contract for additional volume and are prepared to make contract concessions to gain it. At the other end are railroads that are totally opposed to contracts. Most railroads, however, fall between these extremes. Most roads are willing to sign contracts in order to achieve specific tactical objectives, but have tightly circumscribed the standard conditions and terms they are prepared to extend in these contracts. In addition, most railroads have formally defined the criteria which qualify a shipper for contract concessions.

Data developed from shippers by and large corroborated data developed from carriers. Currently more than 70 percent of all rail grain movements appear to be handled under contract. Individual shippers indicated that anywhere from 65% to 100% of their grain moved under rail transportation contracts. However, in recent years, there has been a marked shift away from contracts and towards tariffs. Although most railroads are still signing contracts, several railroads offer the same contract terms and rates to all shippers. Under these circumstances, shippers believe, railroads are beginning to question the practicality and benefit of negotiating contracts, with all their attendant administrative costs and exposure. The following table provides a thumb-nail summary of shippers' perception of the contracting philosophy of each of the major grain hauling carriers.

Summary of Shipper Perceptions of Individual Carrier Contracting Philosophies

Carrier	Contracting Philosophy
BN	With the advent of the COT program, BN no longer signs individual shipper contracts.
Soo Line	Handles grain exclusively under tariffs.
Santa Fe	Moving rapidly towards tariffs. Will sign contracts principally to protect competitive traffic.
UP	Major focus is on receiver contracts
C&NW	Eager to protect relationship with a limited number of large volume receivers, consequently, reluctant to sign contracts that may undercut these shippers.
CSX	Prefers receiver contracts, volume oriented. Unlike its competitors, still insists on minimum volume commitments.
CR	Like its other Eastern counterparts, its primary focus has shifted to receivers. Does not insist on volume commitments. Does less contracting than other Eastern carriers.
NS	Also focussed on receiver contracts. Tends to give the same deal to everyone.

Interestingly, the shippers perception of the contracting philosophy of carriers generally conforms to the carriers own perception of their contracting philosophy. This is not surprising given the efforts made by the carriers in the past few years to formalize and articulate their marketing and contracting policies.

Future of contracts. Most shippers believe that rail grain contracts are useful and will continue to be needed. However, shippers perceive a decline in the number of contracts and also of the volume of grain moving under contract. They perceive that this decline results from, among other factors, the desire of several carriers to avoid the legal exposure associated with grain contracting and disclosure. In the future these shippers expect an increasing percentage of grain to move under tariffs. Contracts will be limited, more and more frequently, to situations where railroads need to protect their markets or desire to provide unique value added services.

Impact on Rail Efficiency. Shippers' opinions on whether or not contracts have influenced rail productivity are divided. Several shippers feel that railroads have been able to reduce costs through contracting. These shippers believe contracts have enabled railroads to improve service design, preplan operations, increase car use efficiency, reduce terminal detention, reduce railroad clerks, and concentrate traffic on fewer rail lines. However, shippers we interviewed were unable to cite specific examples of productivity gains. Little hard evidence appears to exist indicating the extent, if any, to which contracting has enabled railroads to improve their operations or reduce their operating costs.

Other shippers stated that contracting has had no impact on the cost of rail transportation, on car supply, or indeed on shipper's willingness to move freight by rail. They feel that major improvements in rail productivity, which have enabled railroads to reduce costs and lower prices for grain transportation, have resulted from other factors -- principally from deregulation and from soft grain markets in the 1980's when transportation supply exceeded demand.

Receiver Contracts. A pervasive trend since the mid-80's has been a marked shift from shipper to receiver contracts. All shippers with whom we spoke agreed that contracts had become almost universally receiver-oriented. The shippers interviewed believe that a variety of factors have contributed to this trend:

- Railroads have developed a better understanding of the grain markets in which they participate in and their respective roles in

these markets. They better understand who controls the movement of grain and the effect of rail pricing on underlying grain markets.

- Receiver contracts enable the railroads to "level the playing field." Under commercial schemes, which include volume incentives, all freight moves initially under tariff rates, and all shippers pay the tariff standard. Subsequently, at the end of a contract period, the receiver files for an incentive refund, which in many cases, is tied to the volume received. In this way, railroads eliminate any exposure from complaints relating to price discrimination while "leveraging" receivers who control grain sourcing decisions. Receiver-oriented programs encourage large receivers to source more of their grain on the contracting railroad.

Some shippers claim that this trend has resulted in smaller shippers paying higher freight rates. Since larger shippers are, in many cases, also the receivers (export terminal operators, processors, etc), their position upstream in the grain distribution channel allows them to pass through as much or as little of the rail "give back" as is required to source grain competitively. In weak markets like those which existed in the 1980's, receivers have limited need to give back the entire volume incentive.

Contract Terms. Shippers we interviewed reported that 75% of all contract grain movements are handled under contracts with a term of 6 months to one year. Contracts with a shorter term are negotiated for spot or off-season moves, generally when surplus equipment is available. Typically shippers attempt to negotiate for the following contract commitments from carriers with whom they deal:

- Discounted rates below published tariff rates
- Guaranteed car supply. Few railroads, however, are guaranteeing equipment today (with the exception of the COT's program)
- Multiple car or unit train discounts
- Protection against price increases for the duration of the contract.

In return, shippers often guarantee a minimum annual volume (though this appears to be a declining trend) and use of private equipment, where relevant. The ability to guarantee a larger volume enables a shipper or receiver to secure better rates and contract terms from some railroads.

6.2 DISCLOSURE PROCESS

Only one shipper, out of all those interviewed, indicated that he had formally requested, through the ICC, that he be granted access to the contract of a competitor. The vast majority had never felt the need to use secondary disclosure procedures. Most shippers are able to ascertain through bids, through conversations with their customers and through contract summaries, the freight transportation charges paid by their competitors. On occasions when they have questions, they simply call up railroad pricing officers for clarification. Although the railroads never furnish them the rate included in their competitors' contracts, most shippers felt that the informal process enables them to obtain sufficient information to satisfy most of their requirements. Therefore, most shippers have never felt the need to file a formal request for disclosure with the ICC. Also the cost associated with second-tier disclosure has discouraged its use. Consequently, the informal process is used extensively (though less rigorously than outlined in the disclosure rules), whereas the formal disclosure process is used only infrequently.

Most shippers are satisfied with the current disclosure process and seem to think it works satisfactorily. Many of the larger companies have been able to use it for a purpose it was not originally intended, namely, to gain market intelligence on their competitors. Several large shipper organizations subscribe to ICC contract monitoring services based in Washington, D.C. One shipper indicated that primary contract disclosure had enabled him to penetrate new markets which, in the absence of disclosure, he would not have identified as a potential opportunity.

6.3 BENEFICIARIES OF CONTRACT DISCLOSURE

There is little agreement among shippers about the principal beneficiaries of the disclosure process, or about those who have been advantaged or disadvantaged by contract disclosure. Among those mentioned as possible beneficiaries are:

- Small and medium sized shippers
- Receivers
- Railroads

Small shippers have gained in two ways from contract disclosure. Small shippers believe that the disclosure process has created a process of oversight over rail prices by shippers and regulators, and prevented abuses that may otherwise have developed. In response to critical public review, some railroads have tried to "level the playing field." In some cases, commercial policies, based on equal contract terms, have enabled the small shipper to move grain at rates comparable to the "big guy." Middle size and regional companies have benefitted by gaining market intelligence on where the grain is moving and who is moving it. Using this information, they have been able to penetrate new markets.

Receivers have clearly benefitted the most, however, since railroads increasingly sign contracts only with them. As we noted in a prior section, many rail contract programs have become receiver oriented. The most prevalent contracting paradigm within the industry includes incentive refunds in return for large volumes of received grain. These refunds may or may not be passed back to the shipper through higher bid prices, or to the consumer through lower market prices for finished grain products.

Shippers with whom we spoke also claim that the railroads have benefitted -- albeit in a roundabout way. They agree that contract disclosure has given railroads an incentive to move more rapidly back to tariffs, which typically reflect higher prices.

The same groups, for different reasons, also claim to be the ones most disadvantaged. However, even though there is no agreement among shippers as to whom the disclosure process has benefitted or disadvantaged most, there is considerable support for the process itself in its present form. All shippers interviewed did, directly or indirectly, support increased disclosure in testimony before Congress, and most of them continue to support it.

All the shippers interviewed indicated that the disclosure process has had no material impact on how grain is transported or on their decision to transport grain by rail. All, however, felt that disclosure has significantly influenced carrier behavior. Among other effects, disclosure has injected "equalization" as a critical issue in carrier negotiations. "Leveling the playing

field" has become an important basis for characterizing commercial programs. Disclosure has tended to discourage preferential treatment of large shippers for similar service. Disclosure has also helped to redress the substantial negotiating leverage of shippers who have multiple carrier, multiple facility and multiple grain source options. It has also helped to enforce discipline in rate negotiations. Finally, disclosure has encouraged a move away from contracts and a trend to move large volumes of grain under tariff rates.

6.4 IMPACT OF CHANGES IN CONTRACT DISCLOSURE RULES

Many of the observations made earlier in discussing the disclosure process, particularly those relating to the use of the process and its impact on carriers, are the direct result of the changes made in 1987. Other impacts shippers believe are a result of more liberal disclosure rules include the following:

- **Stimulated Carrier Innovation** - The liability associated with grain contracting and disclosure has encouraged railroads to find innovative alternatives to contracts. The best example of this is the BN's COT program which was, to a degree, influenced by BN's desire to avoid the exposure associated with the contract disclosure rules

- **Receiver Contracts** - The process has accelerated the trend towards receiver contracts. Although the total amount of grain moving under contract has not changed over the past few years, the number of contracts has declined and the volume per contract has increased. Typically receiver contracts tend to be for larger volumes than shipper contracts.

- **Rate Equality Among Shippers** - The disclosure process has tended to produce greater equality in rail rates for movement of grain. Many shippers believe that to avoid exposure from the disclosure rules, railroads have generally stopped giving preferential treatment to larger shippers. This was done by moving to receiver contracts, or to tariffs, or by giving the same rate for similar moves (single car, multiple car, unit trains, etc.), in the absence of volume commitments, to all contracting shippers/receivers.

- **Minimal Administrative Cost** - The disclosure rules imposed no additional cost on shippers, and a minimal amount on railroads. The major administrative burden on railroads is the reporting

associated with contracts, not that associated with the filing of contract summaries.

- **Willingness to Contract Unimpaired** - Shippers generally believe that changes in the contract disclosure rules have not had any effect on their willingness to enter into contracts, to move freight by rail, availability of covered hoppers or the costs of transportation.

- **Broad Scope Coverage/Disclosure Camouflaged** - The disclosure rules have encouraged shippers to include more origins and destinations and a larger number of commodities in their grain contracts than are actually involved in the grain moves. This is done to disguise the actual movements.

6.5 SHIPPERS PROPOSED CHANGES TO CURRENT CONTRACT DISCLOSURE RULES

The vast majority of shippers support disclosure and believe that current disclosure requirements are adequate. Indeed, they would like to keep the present rules in place. Some of the smaller shippers, and the brokers who represent them, would like to see more complete disclosure - including disclosure of all prices and economically relevant conditions included in the contract. Most shippers, however, felt that the current system was working well and should not be disturbed. Some did feel that the following information contained in contract summaries needs to be eliminated (or changed).

- Origins and destinations
- Rail car data
- Reporting on 40% limitation on total cars dedicated to contracts
- Volume break points
- Reference to base rates and charges
- Special features relating to credit terms, transit time commitment, and other items.

However, as Figure 6.1 demonstrates, shippers are much less supportive of modifications to existing disclosure practices than are carriers.

There is strong shipper support for the present practice of allowing transportation services to commence prior to filing or prior to approval of a contract. The current rules do not establish a time limit on how soon after the

transportation service has commenced the contract and summary should be filed. Several shippers felt that a reasonable time limit should be mandated by the ICC. One final point of concurrence: Strong shipper support appears to exist for maintaining the current second tier disclosure rules.

Figure 6.1
PRIMARY DISCLOSURE REQUIREMENTS:
ASSESSMENT OF SHIPPER INTERVIEWEES
(Percent of Interviews)

	Retain	Eliminate	Change
Specific Commodity	89%	0%	11%
Shipper Identification	89%	11%	0%
Origins & Destinations	67%	11%	22%
Contract Duration	100%	0%	0%
Rail Car Data	67%	22%	11%
40% Equipment Limit	78%	11%	11%
Minimum Volume	67%	22%	11%
Volume Breaks	67%	22%	11%
Base Rates	67%	11%	22%
Escalation Provision	78%	11%	11%
Special Features	56%	33%	11%

7.0 OVERALL IMPACTS OF CONTRACT DISCLOSURE

In order to determine the impacts of contract disclosure, we interviewed a number of participants in the rail grain contracting business - including carriers, shippers and receivers. From these interviews, as well as a close review of ICC proceedings, Congressional records and published articles, reports and research papers, we were able to identify the key issues and concerns underlying legislation on rail contracts and contract disclosure and the extent to which the contract disclosure requirements have addressed these issues and concerns.

The major issues that the legislation and ICC's interpretation and implementation of the legislation attempted to address can be grouped into the following categories:

- ***Small Shippers vs. Large Shipper Issues*** *- These issues address differential treatment among shippers in contracting practice.*

- ***Carrier vs. Shipper Issues*** *- These issues include the need for regulatory limitations and oversight constraints on the contracting practices of individual carriers.*

- ***Efficiency Effects of Disclosure*** *- These issues address the impacts of disclosure requirements both on efficient grain market operations and on rail operating efficiency.*

- ***Costs of Disclosure Compliance*** *- These issues involve the identity of market participants who shoulder the principal cost of disclosure compliance.*

- ***Benefits of Disclosure Compliance*** *- These issues involve the identity of market participants who enjoy the principal benefits of disclosure compliance.*

Each of these issues is discussed in the sections which follow.

7.1 SMALL SHIPPER VS. LARGE SHIPPER ISSUES

Both Section 208 of the Staggers Rail Act and the Commission's final rules in Ex Parte 387 allow a significant area for interpretive latitude to individual carriers in developing their own grain contracting policies. As we discussed above, some carriers have elected to contract only with grain receivers. Some carriers have elected to contract differentially with shippers based on their willingness and ability to make annual volume commitments. Still others have attempted to segment the markets they serve into different categories -- export, domestic grain processors, feed lot operators, etc. -- and to offer differentiated price/service packages to each of these market segments.

In general, small shippers -- country grain elevator operators, grain brokers, farmers coops -- are concerned that confidential contracting puts them at a disadvantage vis-a-vis large shippers who hold preferential rail contracts. As we mentioned earlier in section 1.2, their concern is based on the fact that traditional "basis point" pricing structures are closely tied to published tariff rates. Confidential contracts changed this situation and injected more uncertainty and more risk into the distribution channel. Most of this risk shifted to the small volume grain shippers who typically do not hold contracts with rail carriers and who did not have certain information concerning confidential contract terms.

7.1.1 IMPACT OF CONTRACT DISCLOSURE

The impact of contract disclosure on large shippers versus small shippers has several dimensions. Indeed, the impacts of disclosure have been both direct and indirect.

Receiver contracts. As we explained in the previous section, railroads have aggressively moved to receiver contracts in the past few years, in part, to avoid the exposure associated with second-tier disclosure. Figures 7.1 and 7.2 demonstrate that the emphasis in grain contracting since 1987 has clearly been on receivers.

Figure 7.1

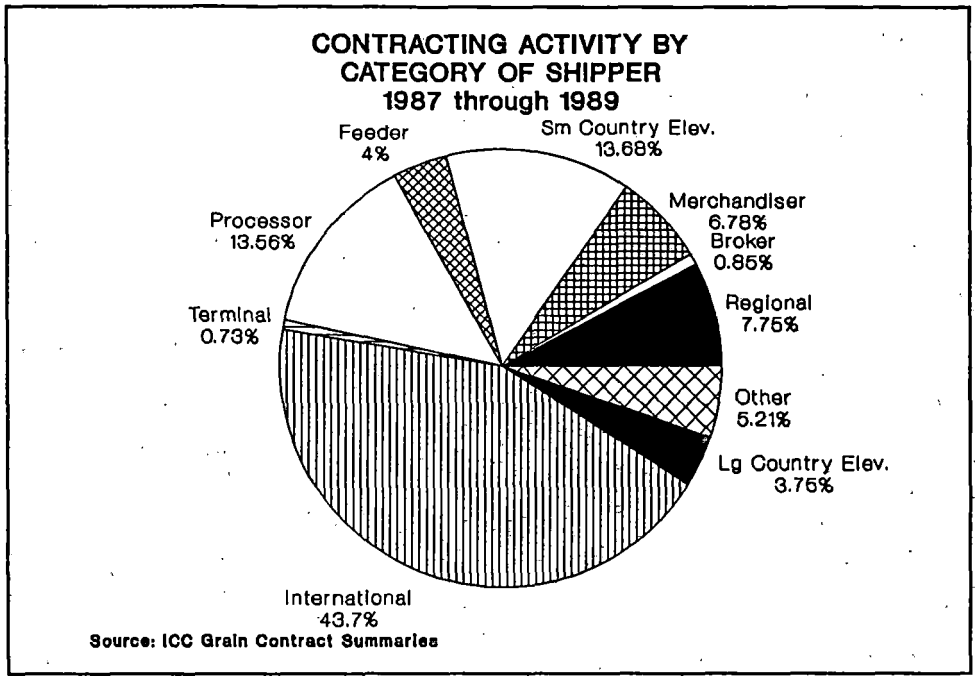
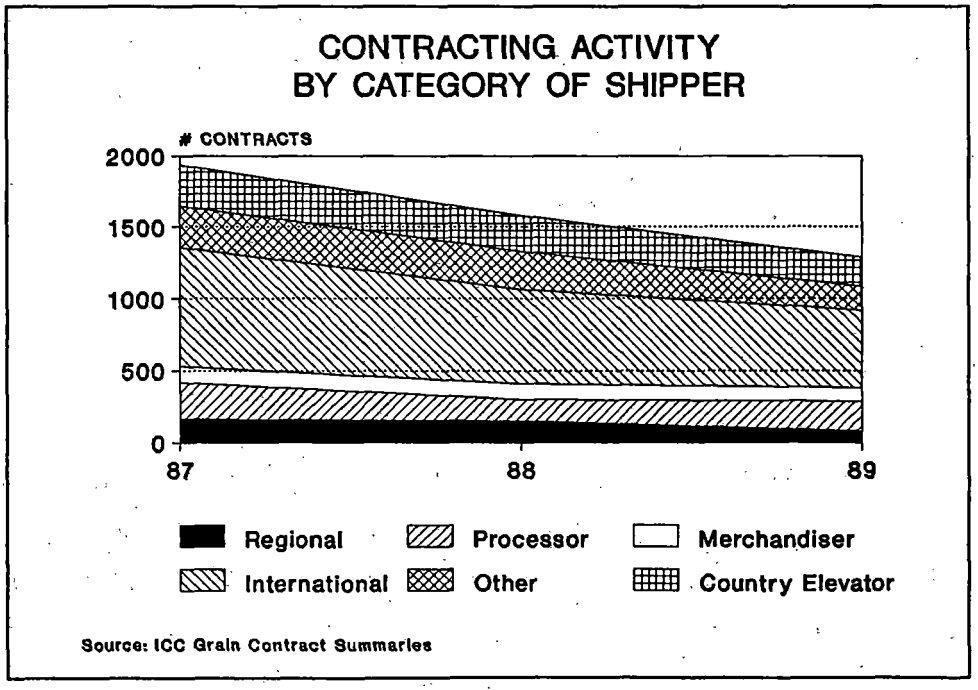


Figure 7.2



Receiver contracts enable the railroads to "level the playing field." Under commercial schemes, which include volume incentives, all freight moves initially under tariff rates, and all shippers pay the tariff standard. Subsequently at the end of a contract period, the receiver receives an incentive benefit in the form of a refund, which in many cases is tied to the volume received. In this way, railroads eliminate any exposure from complaints relating to price discrimination while simultaneously providing incentives to receivers who control grain sourcing decisions.

Effects of Rail Marketing Programs. Railroads have tended to charge similar rates for specific types of services, such as single car movements or unit train movements, to better reflect the economics of providing such services and to avoid exposure to disclosure rules. To the extent that small shippers cannot move grain in multicar lots or in unit trains, they incur relatively higher transportation costs compared to large shippers. Also, to the extent that a small shipper is dealing with receivers who are contract holders, he may not be able to share in some of the contract benefits enjoyed by the larger shipper. Contract disclosure has forced the railroads to formalize their marketing programs and to standardize terms and prices for qualified contract holders that fall within clearly defined service classes or market segments. As we noted above, the marketing programs of individual railroads vary widely:

- Some carriers, such as the Soo Line, have reverted, in large part, to tariffs.

- Several other carriers have shifted to receiver contracts. In many cases, grain moves under tariff rates, and the receiver secures a major benefit at the term of the contract, in the form of volume discounts or refunds.

- Only a few carriers continue to use contracts to segment their markets and to leverage volume commitments from large shippers.

- Changes in contract disclosure have also caused railroads to be more innovative in order to avoid the exposure associated with disclosure. The best example of this is the BN's COT's program.

Willingness to Enter into Contracts. Although shippers stated that

contract disclosure rules have had no effect on their willingness to enter into contracts, this is not exclusively true on the railroad side. Contract disclosure has had a significant effect on the willingness of several railroads to enter into contracts. Some, such as the Soo Line and Burlington Northern, have moved in large part away from contracts to tariffs. Other carriers such as ATSF and CSX are beginning to move more and more toward tariffs. A large number of other railroads have shifted from shipper to receiver contracts, and simply do not sign contracts with some shippers.

7.2 SHIPPER V. CARRIER ISSUES

Railroads. In general, railroads favor increased contracting flexibility and a narrowly defined realm for contract disclosure. Liberal disclosure limits the ability of railroads to segment grain shippers into homogeneous categories each of which can be dealt with on a differentiated basis. The operative concept here is tailored service packages. Ideally, railroads would like to tailor price and service packages to the unique needs of each customer. Open disclosure limits tailored provisions that can be included in a contract, since open disclosure entails that equal contract terms be available to all shippers or receivers who are similarly positioned. Disclosure opens contract terms to general classes of customers, who qualify on some pre-determined basis, for equal treatment.

Disclosure first provides an open basis for discovering confidential terms and then the commercial leverage through which preferred contract terms, offered to selected customers, may become general terms offered to large groups of customers, to many of whom rail carriers may have had no intention of offering them in the absence of disclosure. Moreover, a major "disclosure incident" could severely undermine the trust and confidence of contracting parties whose confidential relationship may be violated through disclosure. In the opinion of most rail carriers, confidentiality is fundamental to the right to contract. Open disclosure not only undermines this right but also affords third-parties, who are not involved in a contract, the opportunity to claim preferred terms that the contracting railroad may not want to offer to them. To the extent that contract disclosure is open and that information access to

confidential contract terms can be easily gained, carrier and shippers both will be less willing to enter into contracts.

Moreover, competing modes - barges and trucks - have no requirement to disclose their contract terms with grain shippers. This asymmetry in regulatory oversight is particularly galling to rail carriers. Several rail carriers suggested that they were competitively disadvantaged vis-a-vis competing barge and truck competitors because of the unique regulatory requirements involving rail contract disclosure.

Small shippers. The position of shippers is more ambivalent. In general, small shippers are concerned that they will be disadvantaged by contracts that offer preferential terms to large shippers and that put small shippers in a potentially disadvantaged economic position. Hence small shippers generally favor open contract disclosure and an active intervention policy on the part of the Interstate Commerce Commission. Such a policy has the effect of "leveling the playing field" between large and small shippers.

However, short of outright regulatory intervention to equalize contract terms, small shippers perceive that open disclosure has the effect of improving their contract negotiating leverage. They believe that access to disclosed contract information is valuable, in and of itself. It sets a clear parameter on how far carriers are willing to go in making contract concessions.

Large Shippers. Large grain shippers have a different perspective. Their interest in contract disclosure is principally to track their competition and, to monitor shippers who perform the same functions within the grain distribution channel as themselves. Large grain shippers monitor grain bid prices and market activity closely. They likewise track information concerning transportation rates and rail contract terms. Their concern is less with equity among large and small participants within the grain distribution channel than with monitoring the competitive transportation cost advantages or disadvantages specific competitors may have achieved through contract negotiations. In general, large shippers favor limited contract disclosure -- disclosure that gives them sufficient information to identify new market developments without also revealing prices. Through their grain trading

activities, large grain traders are able to infer the transportation costs their competitors bear and their competitive cost relationship with these competitors. Contract disclosure is valuable to them as an early warning system, which identifies new market openings and new movement opportunities.

7.2.1 IMPACT OF CONTRACT DISCLOSURE

Rail rates. Since the passage of the Staggers Act, rail grain rates have declined, in both real and nominal terms. As we noted in Chapter 2, this resulted from a combination of factors that collectively resulted in a buyer's market during this period. Key market factors included:

- Volatile and declining export markets resulting from
  - the 1979 grain embargo
  - increased value of the dollar, and
  - sharply increased foreign production of grain.
- Surplus car capacity
- Intense rail competition

During this period, railroads attempted to retain or gain market share by lowering rates through contracting. The situation changed sharply in the late 1980's, however, when equipment supply began to more closely balance grain traffic demand. Also, as we discussed in Chapter 6, changes in the contract disclosure rules set in motion a trend away from contracts to tariffs which tend to set the ceiling on prices; contract prices had typically been set below tariff rates. This in turn has tended to boost average rail rates in the late 1980's.

In addition, disclosure has affected the shape of rail marketing programs that have emerged since the passage of the Staggers Act. Contract disclosure rules for grain have reduced the ability of railroads to micro-segment their markets and to treat their customers differentially. Disclosure has also injected more concern with "equal treatment" among classes of customers.

7.3 EFFICIENCY EFFECTS OF DISCLOSURE

Grain Market Operations. Grain grows in a variety of geographical locations throughout the U.S. These local markets are integrated into a national market place through a transportation network and through institutionalized markets. The grain market is complex and involves a number of forward pricing and risk hedging mechanisms. These mechanisms allow the value of grain to be determined at locations throughout the U.S., both currently and up to one year forward. These mechanisms also allow buyers and sellers to make individual sales decisions at times convenient to themselves. They further enable buyers and sellers to arbitrage differences in perceived value. Most importantly, however, these mechanisms provide the physical means to move grains from areas and periods of surplus to areas and periods of grain deficit.

Futures markets are essential to this trading process. Futures markets establish the current value of grain for future delivery at centrally located grain distribution centers up to 18 months in advance of delivery. Futures prices, in turn, become the reference points for establishing the value of grain in local markets. A country elevator operator typically relates the value of grain he holds to the value of grain in the nearest grain distribution center to which futures delivery contracts apply. The difference in value between his grain and delivered grain to that distribution center is called "basis." Historically, "basis" for grain generating points located near central distribution centers has not fluctuated significantly.

Rail rates and elevator storage costs account for most of the basis differential. An elevator operator can hedge his risk of grain market decline using futures contracts, since cash grain values and future prices move in parallel. "Basis trading" allows a buyer or seller to preserve maximum flexibility regarding when, where, and to whom they trade while assuming only limited risk.

At the beginning of rail deregulation, the prospect of unstable and variable rail grain rates threatened to upset the foundation of basis trading. The volume commitments, and operating efficiency incentives built into rail grain contracts threatened to destabilize basis trading. The concern of grain shippers

with the potential market destabilization effects of rail contracts ran along these lines: Basis relationships depend primarily on transportation costs and the entire grain marketing system depends pivotally on the public visibility and predictability of future transportation rates. The traditional tariff based system provided the stable cost structure for basis trading. That trading system worked extremely well in distributing grain within the U.S.. The strength of the basis trading system is its ability to move the most inexpensive grain to the most economical end-market. The concern of grain shippers was that rail contracting might disrupt delicate market balancing mechanisms.

Shippers felt that if they are contractually obliged to bypass an opportunity to ship to a market whose basis price is high, and instead ship to an alternative destination which is entailed in a rail contractual commitment, the overall distribution process becomes less efficient. Grain may be forced to move to un-economic destinations based on rail contract incentives and more pressing demand may go unsatisfied.

Railroad Operations. A second set of concerns regarding the efficiency effects of contracting relate to rail operations. Congress anticipated that contracting would significantly improve rail productivity. Indeed, carriers appear to have realized a significant improvement in productivity since the passage of the Staggers Act. At the same time, grain rail rates have declined in both nominal and real terms through most of the decade. However, little evidence exists that grain contracting and/or grain contract disclosure contributed directly to improved productivity. Few carriers have set productivity enhancement as an explicit objective for their grain contracting programs.

7.3.1 IMPACT OF CONTRACT DISCLOSURE

Evidence regarding the market efficiency impact of contract disclosure is mixed -- more certain in the arena of grain market operations than in the arena of rail operations.

Grain Market Operations. In the early 1980's, the railroads went through a period of experimentation, in testing their new won freedom to

contract. This period of trail-and-error injected uncertainties into the grain markets and caused understandable anxiety within the grain-shipping community, especially among the small shippers who were no longer privy to the grain transportation prices available to large shippers. This circumstance in turn led Congress to formalize and elaborate the contract disclosure requirements for grain in the 1986 Conrail Act. The disclosure rules subsequently prescribed by the ICC have resulted in more stability and predictability of grain transportation rates. Today, concern about the impact on underlying grain market mechanics is much less a priority than it was five years ago. As carriers have evolved their commercial strategies, they have taken special pains to work within the parameters of their underlying grain markets. Essentially, this is an issue of contract flexibility. As we discussed in previous sections of this report, rail contract practices, for the most part, have evolved rapidly to avoid these pitfalls. The grain trading market has effectively "rewired" around the new contract based commercial paradigms. Today, contract disclosure has limited influence on how whole grain is marketed in the U.S.

Rail Operations. No hard evidence exists to show that contracting or contract disclosure has enabled railroads to concentrate traffic in specific lanes, to improve railroad operating efficiency or car supply. These cause and effect relations operate at a more general level. Competitive pressures, brought about by deregulation, have compelled railroads to make operating improvements. If there is a relationship between contracting and productivity improvements, it is indirect and applies at the level of general market forces.

7.4 COSTS OF DISCLOSURE COMPLIANCE

The costs of contract disclosure compliance fall into two categories: 1) The administrative cost of complying with contract disclosure requirements, and 2) The opportunity cost resulting from precluded alternatives -- not pursued as a result of compliance with disclosure requirements. In both instances these costs are incurred principally by railroads.

One railroad has estimated that administrative costs associated with

summarizing, delivering, and filing contract summaries is approximately $20 per filed contract. Other rail executives could not set a precise unit cost figure, but suggested that the costs were indeed "significant." If we multiply the total number of grain contracts filed with the Commission since 1981 by the conservative unit cost estimate, furnished by one carrier, this represents an average cost to the rail industry of $41,000 per year. The order of magnitude of costs associated with administrative compliance is in the order of hundreds of thousands of dollars over this period.

The much greater cost, however, falls into the latter category, the opportunity cost associated with disclosure compliance. Several railroads indicated that their contracting policies have been influenced by disclosure requirements. The threat of secondary contract disclosure, in particular, appears to have inhibited the more aggressive pursuit of contract opportunities on the part of these carriers, and any desire on their part to push to the limits on differential contract terms. This cost, however, varies significantly among individual carriers depending on their baseline market strategy. We discussed the impacts of disclosure on specific carriers in Chapter 4 of this report.

7.5 BENEFICIARIES OF DISCLOSURE COMPLIANCE

The beneficiaries of contract disclosure, as it is currently practiced, appear to be both large and small shippers. However, they have benefitted in different ways. Large shippers primarily use contract disclosure to monitor the transportation markets in which they compete. They are also in the best position to exercise their contract discovery rights under secondary disclosure and to use this leverage to realize additional contract negotiating advantage.

Although only one "test case" instance of secondary contract disclosure has occurred, many of the railroads with whom we spoke acknowledged their apprehension about becoming involved in an adversarial proceeding requiring secondary disclosure. Most of these carriers believed that the commercial costs of full contract disclosure would be more severe than the punitive cost resulting from an adverse regulatory finding. In their opinion, the disruption of customer relations and the revelation of confidential terms could carry with it a severe

commercial penalty, a penalty measured in lost traffic volume, injured commercial relationships, and loss of market credibility.

Primary disclosure provides adequate information for most shippers to be able to figure out the approximate rate included in the contract by looking at the origin and destination information and the name of contract holder. The desire of a majority of railroads to offer standard price/service contract packages to shippers who fall into well defined classes of market participant, is at least, in part, due to disclosure checks and balances. In the context of specific carrier marketing programs this predisposition to equal treatment, together with the threat of disclosure, has enabled small shippers to enjoy rates more competitive with those available to larger shippers.

Since the new disclosure rules became effective in 1987, a marked trend has emerged among railroads to move away from differentiating shippers through contract pricing. Individual carriers have adopted various strategies to "level the playing field" and avoid the liability of secondary disclosure. Some, for example, have gone to a tariff format, while others have shifted exclusively to receiver contracts with standard terms. One railroad has developed a new pricing mechanism allowing grain market mechanisms to work in an open market to determine rail rates. These diverse strategies provide essentially the same rates and equal opportunity to secure these rates to all contract holders for similar movement patterns and services. In this sense, contract disclosure has had a leveling effect on many carriers' strategies. Disclosure rules have also contributed to innovation in rail marketing. The ultimate beneficiaries of these programs are again the shipper participants.