

RAIL FREIGHT IN THE USA: LESSONS FOR CONTINENTAL EUROPE

BY HENRY POSNER III
RAILROAD DEVELOPMENT CORP.

JANUARY 2008

The Voice of European Railways



Henry Posner III



Henry Posner III is a founding principal of Railroad Development Corporation (RDC) in Pittsburgh, Pennsylvania (USA). He entered railway service at Conrail, where he served in various operating, marketing, planning and sales positions. A graduate of Princeton University (BS – Civil Engineering), Mr Posner also holds an MBA in Finance from the Wharton School

Mr Posner serves as Chairman of RDC, a railway investment and management company with interests in the USA, Argentina, Peru, Guatemala, Malawi and Mozambique. RDC was also a shareholder in Eesti Raudtee (Estonia) until its renationalization in January 2007. He serves as Chairman of Iowa Interstate Railroad; Chairman of Ferrovías Guatemala; a Director of América Latina Logística-Central (Argentina); and as Vice President of The Hawthorne Group.



CER is happy to present another essay written by a distinguished non-European rail transport expert. Henry Posner III, Chairman of the US Railroad Development Corporation, compares the rail freight markets in the US with those in continental Europe, and provides some highly insightful analysis into why US rail freight market shares are significantly higher than those in Western Europe.

We hope that this presentation of the structural and institutional differences between the US and the European markets, as well as the business trends here and there, helps to stimulate the debate on the future of the whole industry.

I wish you an enjoyable read.

Johannes Ludewig
CER Executive Director



RDC has been a direct investor in railways on four continents—the USA, Latin America, Africa, and until January 2007, Europe, when RDC was one of the shareholders of Estonian Railways. We are a small company and most of our businesses are joint ventures with other shareholders. We have found joint ventures to be a successful formula and it is usually our partners that make or break the business.



RDC Businesses

Country	Entity	Length		Employees	Average Annual Tons (in millions)
		Km.	Miles		
USA	Iowa Interstate	1,005	623	185	6.2
Argentina	ALL Central	5,350	3,324	1,012	3.4
Argentina	ALL Mesopotamica	2,740	1,703	313	1.4
Guatemala	Ferrovias Guatemala	322	200	100	0.13
Peru	Ferrocarril Central Andino	490	304	169	1.7
Malawi	Central East Africa Rwys	797	495	441	0.2
Mozambique	Nacala Corridor	872	523	227 (Rail)	0.2
Estonia	Eesti Raudtee ¹	693	431	2,389	44.3

1. Re-nationalized Jan. 2007

Differences between North America and Europe

To begin, it is important to note that many fundamental characteristics of Europe and North American railways are completely different and Table A attempts to summarize them.

Table A
Fundamental characteristics —Differences between North America and Europe for rail freight

	North America	Europe	Comments
Distances	Long	Short	Rail is more competitive over long distances
Traffic Patterns	Concentrated	Fragmented	Concentration of traffic on high-density corridors is important from both an efficiency and service perspective
Competition	Other Rail	Truck	In most North American markets there are two or more railways, operating parallel routes, in addition to pervasive truck competition.
Capacity Constraints	Line Capacity	Passenger priority	In North America, downsizing of multiple tracks and parallel routes has eliminated excess capacity. In Europe, the ability to handle traffic as simple as steamship containers efficiently is often constrained by the clearance envelope of passenger-oriented infrastructure.
Orientation	Freight	Passenger	In North America, railways are oriented toward freight transportation, whereas in Europe freight is strictly a secondary priority due to focus on passenger service.

But one thing to consider is that the Chinese Railways and the Russian Railways are much more like North America than they are Europe. So when discussing, for example, transcontinental traffic, it is important to keep in mind that if the route includes China or Russia, those railways have the same fundamental characteristics as North America, at least according to the list in Table A.

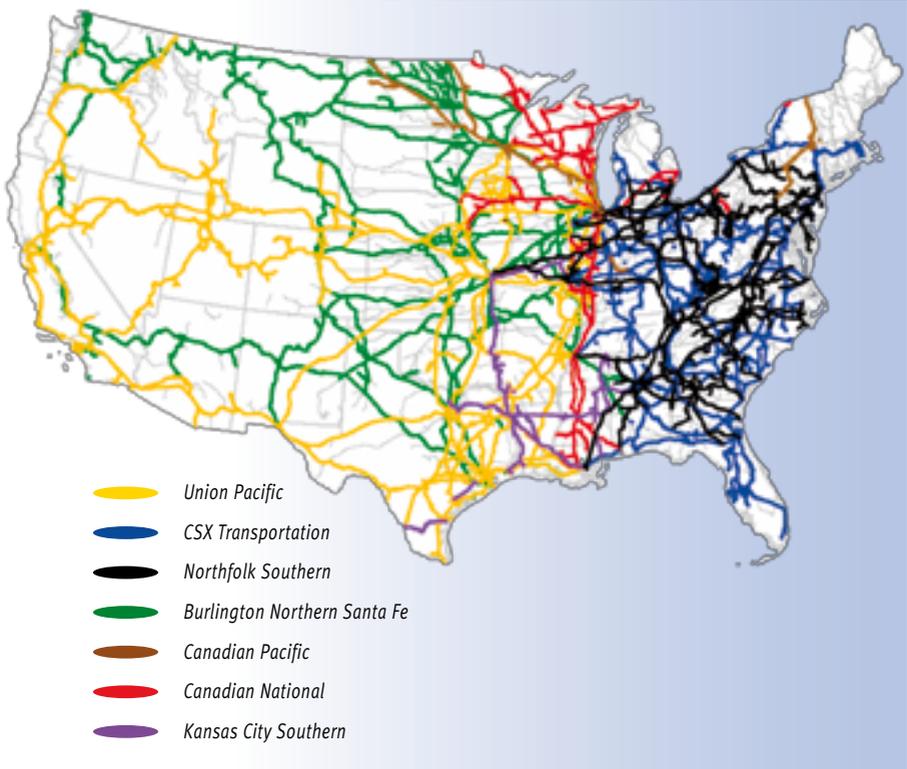
I would like to focus, however, on another type of difference which is not often discussed — the institutional differences. In some respects Europe is even more different from North America institutionally than it is physically, as summarized in Table B. In North America the driver is competition, whereas in Europe it is regulation which, in my opinion, explains in part why we have such a successful freight business in North America while Europe is struggling.

Table B
Institutional Differences between North America and Europe

	North America	Europe
Rail Policy	Competition	Regulation
Rail Competition	Parallel Rail	On-Rail
Infrastructure Control	Operator	Regulator
Infrastructure Funding	Private	Public

In North America rail competition is usually railways running in parallel with each other, competing imperfectly for the same market, which allows each railway to make a profit in certain niches. For example, our Iowa Interstate Railroad (IAIS) is paralleled by the Omaha/Chicago main lines of three much larger carriers (BNSF, UP and CN), but survives by serving as a feeder of traffic from points on IAIS to points on the above-mentioned railways, as well as other railways. This is best illustrated by the following map of the North American rail system, which shows numerous instances of parallel competition.

North America – Parallel Competition in USA



In contrast, in Europe the objective of EU policy has been on providing perfect on-rail competition; thus in the long run no operator is going to be able to make a profit, much like the airline industry in North America.

Finally, note that in general in North America the funding is private and in Europe it is public. North American railways have historically funded both maintenance and capital improvements from internal cash flow and commercial sources of finance; the most dramatic recent examples are the addition of second tracks on BNSF's Chicago/Los Angeles main line and UP's Los Angeles/Texas main line.



Freight Business Drivers

But what really drives the freight business? Table C shows, in descending priority, a list of what I see as driving the business. This is listed first for customers, who are the most important; and second, comparing customers' priorities with those of railway policies in North America and Europe.

Table C
Freight Business Drivers (descending priority)

Priorities	For customers	For North American policy makers	For European policy makers
		Competition as Result of Deregulation	Regulation Forces Competition
1	Intermodal Competition	Intermodal Competition	Intermodal Competition
2	Capacity	Capacity	Intramodal Competition
3	Service	Service	Service
4	Intramodal Competition	Intramodal Competition	Capacity

Please note that, in my opinion, the first thing that customers want is intermodal competition, i.e. rail as an option vs. truck transportation. If the rail option doesn't exist, then everything else is academic. Where the differences occur, is that in North America there is competition through deregulation, whereas in Europe there is competition through regulation. This is an extremely important institutional point because it has nothing to do with engineering, signaling systems or axle loads. It is an institutional fundamental of the European environment, and I think it is the single biggest problem.

The origin of deregulation in North America was primarily the result of the many bankruptcies in the late 1970s. Twenty-five percent of the rail mileage in the USA was in bankruptcy and it really was a question of whether there was going to be a rail industry or not. The government's response was, "Too bad ; there's no money for you; fix your problems. But we will allow you to go out of business if you choose. We will allow you to price your business without regulation if you choose. And we will give you complete freedom to exit markets or restructure yourselves to serve those markets." The end result was that we have a smaller industry but an industry that is more profitable than it's ever been. We still can't fund all of the capacity that we need, but this is a far cry from the time that I entered the rail industry in 1977. So this is why I say that the most important factor is making sure that rail exists as an option.

The second most important factor is providing the capacity, or in some cases adjusting the capacity to the market. Once you have the capacity, then you can talk about service. And after that, only then is it possible to talk about competition.

In Europe, in my opinion, the focus has been more on promoting intramodal (rail vs. rail) competition even before considering service or capacity, so the priorities have been reversed and I think that explains much of the results. From an overall perspective, in order for rail competition to exist, there must be capacity and service before a customer can, for example, start playing block train operators against each other.

Trends in the Freight Business

Table D shows what I consider the main trends respectively in the North American and in the European market:

Table D

	North America trends	European trends
Wagonload Traffic	Stable	Declining
Operator Focus	“Common Carrier” (multi-market trains)	Customer-Specific trains
Financial Performance	Stable	Declining
Market Share	Increasing	Declining
Ownership	Private	Public

Using wagonload traffic as an example, we have a stable business in North America but this is a declining business in Europe. I say “stable,” while some of my colleagues in the USA prefer the term “growing.” Yes, it is growing but it is still not enough to pay for all of the capacity that we need. So yes, it is successful but it could be more successful.

But I think that the most important line is the second line — operator focus. In North America we are common carriers handling multi-market trains, meaning that freight railways handle containers, coal, wagonload traffic, etc. By contrast, in Europe the trend is toward customer-specific block trains. This is not a healthy sign, and I think that is reflected in the financial performance where the freight business is being shrunk to what in the long run may end up just as a block train business.

Some Final Thoughts

Let me leave you with some final thoughts, which are at least indirectly connected with what I have just said. RDC now has European experience through our 5+ years of shareholding in Estonian Railways. I would argue that, based on our experience, EU Accession increases the power of the regulators at the State level but without the oversight; this is an invitation to political interference. For example, when the railway regulations were changed in Estonia, the EU response was that it was legal and that doing so was certainly within Estonia's powers; moreover, in response to our claims that the laws were unfair and represented confiscation of our investment, the EU said that they really had no control over how EU norms were interpreted.

Second, regulation is an invitation not only for political interference but also an invitation for corruption. Whenever you have increased power through a regulator of something that is valuable, and the rail freight business in Estonia is a valuable and profitable business, you are inviting corruption.

Third, regulation does very little to stimulate rail traffic; it merely redistributes it. A good example of that is the UK, which is seeing the same coal movements being fought over by different open access companies. Further detail on this is provided below as a case study.

The underlining message of all of the above is that the private sector cannot compete with the agendas of public institutions, and that the power of public institutions is actually increased as result of the presence of the EU. So whatever the problems were before, they are getting worse.

This is a pessimistic message so I want to close with some positive contributions. I would therefore like to make three suggestions:

1. It is important to have customers as part of the dialogue and in particular, wagonload customers. Dialogue with block train customers is less critical because their hidden hand is behind each and every block train movement that train operators are competing for. Maybe it already exists, but if there could be some sort of a group of wagonload customers sitting at the table at, for example, rail freight conferences, I think that would be extremely helpful to all concerned.
2. I think that as an industry, a focus on the wagonload business is like the “canary in the coal mine.” In countries where the wagonload traffic has disappeared or almost disappeared, rail freight is sicker than in other countries like Sweden where they have held on to much of the wagonload traffic. The problem with converting customers from wagonload traffic to, for example, intermodal, is that you are teaching them how to use trucks. You are also converting them into a business where, if you are successful, some other operator is going to start a competing intermodal business and take it away from you.
3. And finally, there are still some very valuable lessons to be learned from the North American wagonload business, which is a profitable niche business largely due to the fact that, by providing service from private siding to private siding, the need to involve truck transportation is eliminated. This is a model from which elements can be successfully transplanted into the European context in many countries in continental Europe where wagonload traffic survives.

For the above reasons, I extend a welcome to CER members interested in coming to the USA to see why, although the environment is completely different, there are still some aspects of our business that should be useful to Europe.

CASE STUDY: Open Access in the UK

In July 2005 the UK's Rail Freight Group issued a news release reporting a "huge rise" in freight moved by rail in 2004-2005 compared to 2003-2004, using data from the Strategic Rail Authority's National Rail Trends Yearbook:

http://www.sra.gov.uk/pubs2/performance_statistics/Nat_trends_yearbook/Nat_Year.pdf

"Overall traffic was up 9.5 percent to 20.7 billion net ton kilometers, the highest total since 1977, and marking 60 percent growth since 1995.

The greatest commodity increase was for coal, which jumped a massive 27.5 percent. There was also a substantial rise in domestic intermodal traffic, which increased by 14.5 percent to 4 billion net ton kilometers, the highest level ever recorded in National Rail Trends."

However, pp. 28-30 of the yearbook tell a much different story. While ton kilometers are up dramatically, tons originated are flat, and non-coal actually declined.

Net ton kilometers:

1995 – 1996 13.3 billion (3.6 billion was coal)

2004 – 2005 20.7 billion (7.0 billion was coal)

Net tons:

1995 – 1996 100.7 million (45.2 million was coal; i.e. 55.5 million non-coal)

2004 – 2005 101.9 million (51.7 million was coal; i.e. 50.2 million non-coal)

In fact, the main driver of growth in ton kilometers was the collapse of the UK's domestic coal industry, as the length of haul for imported coal from ports to power plants is on the average greater than it was from domestic mines to power plants.

But even this does not reveal the most important conclusions, which are that:

- For the coal business, open access has driven prices down to the most aggressive freight operator's perception of variable costs. (Rail costing is an art, not a science, so there is usually a diversity of assumptions as to what constitutes variable costs.)
- For other business, especially new business to rail, on a capacity-constrained system no one has the economic motivation to pay for capacity improvements – not the passenger-oriented and renationalized infrastructure company; not freight operators exploring new markets; and certainly not customers.
- Adding to the disincentives is that new business, if successfully identified and developed, becomes an easy target for cannibalization by other competing freight operators.

The implications of the above are, by my mind, quite clear: namely, that the economic effect of open access has been the conversion of bulk traffic from the rail industry's highest margin business into its lowest margin business, with a catastrophic impact on the industry's ability to fund its infrastructure.

Policy makers are therefore well served to study the UK experience before any further debate on the subject can be considered serious.

And rail users need to be very, very careful what they ask for.



Title previously published in this series:

Jan Sundling : “Developing rail logistic operations in Europe:
Perspectives from Sweden”,
September 2005.

George Muir : “The Railway in Britain: on the right lines”,
February 2006.

Yoshio Ishida : “The break-up and privatization of Japan National Railways
and management reforms at JR East”,
December 2007.

