OPEN ACCESS — *from theory to reality*

REMARKS BY
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Since we are The Lexington Group in Transportation History, I would like to use history as a valuable tool for us in the USA because there is now a world history of Open Access. I would like to document this by going back to 1995 when RDC first took a look at Open Access as it was then in the UK. I will use actual slides from presentations that we made in 1995 and 2001, and then some research done in 2005, to drive stakes into the ground and show you what the theory was about Open Access–and how it then was translated into reality. And by driving those stakes into the ground I hope that this will help in driving a stake into the heart of the arguments for Open Access.

Background on RDC

RDC is a small private company based in Pittsburgh. We focus on *Emerging Corridors in Emerging Markets*. The key is that everything we do, with the exception of the Iowa Interstate of which we own 100%, we do with partners as joint ventures. Table 1 shows a list of our various railroads around the world. I'll point out that we are only 3.6% in Estonia so I don't want to mislead you and give you a false impression of a huge mega-enterprise run out of Pittsburgh. In most cases, we are minority investors with the exception of the Iowa Interstate and Ferrovias Guatemala where we are the majority investors. (In the case of Guatemala, we couldn't find anyone else who wanted to be the majority investor.)

Table 1
RDC Businesses

Country	Entity	Length Km (Miles)	Employees	Tons Y. 2005 (in millions)
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 Railways	797 (495)	487	0.24
Estonia	Eesti Raudtee	693 (431)	2,389	44.3
Mozambique	Nacala Corridor	872 (523)	227 Rail	0.27

Also note the broad range of sizes of these railways, ranging from Guatemala where we move 130,000 annual tons versus Estonia which moves 44.3 million annual tons. Estonia's freight business is almost as big as SNCF's; so this little country's railway is within an order of magnitude of the freight business of the national railways of France; this is big-time railroading.

1995 Britain's Rail Freight Privatization–an investor's view

The Rail Freight Conference • London

But let's first talk about the UK. I will present selected slides from our 1995 presentation and in particular, RDC's view of the world 11 years ago in London, when this was just beginning. The point that I would like to highlight is the one in red in Table 2. Note that the government's objectives for structuring the rail freight business was to improve service and lower transportation costs, as well as reduce or eliminate losses. Or as Ed Burkhardt has pointed out, to put value into the pockets of customers, which is a great idea, up to a point.

Table 2

Global Perspective on UK Privatization – Structure
Rail Privatization Models (freight only)

	USA	ARGENTINA	SWEDEN	NEW ZEALAND	UK	CHILE
FRANCHISE SCOPE	REGION	REGION	BRANCHES	COUNTRY	COUNTRY	REGION
# OF FRANCHISES	1	6	UNLIMITED	1	6 INITIALLY	1 INITIALLY
FRANCHISE TYPE	EXCLUSIVE	EXCLUSIVE	OPEN ACCESS	EXCLUSIVE	OPEN ACCESS	OPEN ACCESS
TRANSACTION YEAR	1987	1991 – PRESENT	1988 – PRESENT	1993	1996? AND BEYOND	1995
INFRASTRUCTURE TRANSACTION	PURCHASE	LEASE	UTILIZATION FEE	PURCHASE	UTILIZATION FEE	UTILIZATION FEE-core lines; LEASE-branch lines
INITIAL ROLLING STOCK TRANSACTION	PURCHASE	LEASE	PURCHASE	PURCHASE	LEASE	PURCHASE
ONGOING SUBSIDY	NONE	NONE	AS NEEDED	NONE	AS NEEDED	NONE
EXAMPLE	CONRAIL	BAP	OSTERLENTAG	NZRL	LOAD HAUL	FEPASA
PRIMARY GOVERNMENT OBJECTIVES:						
REDUCE / ELIMINATE LOSSES	X	X	X		X	X
IMPROVE SERVICE / LOWER TRANSPORT. COSTS		X			X	X
RAISE CASH	X	X		X		X

I think that the key fundamental aspect of Open Access, which is not a surprise, is what you see in red in Table 3. The main competition is other railroads on the same infrastructure and with the same cost characteristics, not to be confused with the USA where the competition is other parallel railroads. In places like New Zealand, there was not only trucking but also intra-coastal shipping, and in places like Latin America and Africa the competition is trucking.

Table 3

Global Perspective on UK Privatization – Fundamentals

		USA	NEW ZEALAND	LATIN AMERICA	UK
REVENUE:	COMPETITION	OTHER RR	TRUCK, SHIPPING	TRUCK	**OTHER RR**
	MARKET SHARE	MATURE	MATURE	LOW	MATURE
	TRAFFIC BASE	MATURE	MATURE	EXPANDING	MATURE
COSTS:	INFRASTRUCTURE	GOOD	EXCELLENT	FAIR	EXCELLENT
	ROLLING STOCK	GOOD	EXCELLENT	POOR	GOOD
	STAFFING	LOW	LOW	HIGH	HIGH
	RAILWAY CAPITAL MARKETS	MATURE	MATURE	EMERGING	EMERGING

Retroactively, the single most important comment in the box below is the last one, "The U.S. domestic airline industry is a model that Open Access may force on the UK with the same competitive and financial results." Unfortunately, I was correct.

Valuing the Freight Franchises

- Under Open Access, a Franchise is not a Franchise.
- Intramodal Competition (rail vs. rail) is likely to **minimize profit margins** as Open Access takes hold.
- Despite mature markets, revenue projections are highly risky due to unknown impact (timing, severity) of majority structural change (Open Access).
- The **U.S. domestic airline industry** is a model that Open Access may force on the UK – with the same competitive and financial results.

Now for the conclusions from this presentation (which was 11 years ago in London!) are that the main benefactors of Open Access would be rail customers. Also, that capital should be available "at the right price" as long as that price is sufficiently low.

Conclusions

- Rational investors unlikely to pay high price, or have significant capital at risk, unless business is truly a Franchise.
- The **main benefactors of Open Access will be rail customers.**
- Capital should be available at the right price.
- Overseas investors should be interested at the right price and with the right partners.

In fact, if you examine what has happened to Open Access in the UK, many of the Open Access competitors are customers who started their own railroad operations and ran them as cost centers, not to be confused with profit centers. Once they were in business, they went after incremental business and the classic example is Freightliner. They were in the container business and then went into the coal business. Another anomaly is that before the balkanization of the UK rail network, a ballast train (or what we would call a work train) is now a revenue freight move. So when you look at the statistics in the UK, keep in the mind that some of the explosive growth is in fact because they are now counting ballast trains. So look behind the numbers when you are presented with anecdotes.

2001 Alternative Models for Freight Rail Concessions—a comparative analysis

Africa Investment Forum–TransAfrica 21 Conference • London

Now let's see what we said in 2001 at the Africa Investment Forum. Typically these are financial audiences because in many regions like Africa, where the continent is large and fragmented, they are looking for help in developing policies. The theme then was the same as it is today: look to history. (Remember, we are The Lexington Group in Transportation History. We create value just by being who we are!) Look to history, look to other examples, look to other models around the world and make your own conclusions as to the merits of Open Access or some variant of the Exclusive Franchise model that we have in North and South America.

Again, what I said in 2001 was that if you look at Europe, why was Open Access done? (Table 4 below) Open Access was done for two reasons: the political objective of "de-monopolization" (highlighted in red). What does that mean? It is a political term that has a broad range of implications. But the single word that is used most often against railways in Europe, and we are beginning to hear the same words, the same Big Lies that came from Europe here in the U.S., is—"monopoly." Sorry, I'm getting emotional……

Table 4

Railway Restructuring's Origins Range from Economic to Political

		NORTH AMERICA	SOUTH AMERICA	EUROPE	SOUTHERN AFRICA
ECONOMIC:	• BANKRUPTCIES	X			
	• LACK OF INVESTMENT	X	X		X
	• OPERATING LOSSES		X	X	X
POLITICAL:	• PRIVATIZATION THRUST		X		X
	• DE-MONOPOLIZATION			X	

The prime objective in Europe has been, not the construction of something, but the dismantling of something, i.e. de-monopolization (Table 5). Only secondarily was it to involve the private sector or, as the great British railway journalist Roger Ford is fond of saying, "to involve Dynamic Thrusting Private Sector Management."

Table 5

Producing a Wide Range of Strategies

	NORTH AMERICA	SOUTH AMERICA	EUROPE	SOUTHERN AFRICA
PRIMARY:	DEREGULATION	PRIVATIZATION	DE-MONOPOLIZATION	INCREASED TRADE
SECONDARY:	LABOR REFORM	LABOR REFORM	PRIVATIZATION	PRIVATIZATION

But the market has a way of seeing through politics. If you look at Table 6, note that the price paid for the various UK trainload freight businesses when Ed bought EWS was a fraction of what one would have paid in North America because of the low valuation, which was because of the weaker underpinnings of the Open Access model. Even after these various trainload freight businesses were consolidated into one business and then privatized, the value was substantially lower, at least as a multiple of revenue, than one would have paid for a similar business in North America.

Table 6

	EXCLUSIVE FRANCHISE	OPEN ACCESS
FINANCIAL MARKETS	Customer-specific investment in equipment and infrastructure (USA, Latin America)	Customer-specific investment in equipment (UK)
	Consolidation of Brazilian and Argentine franchises; U.S. rail mergers	Consolidation of UK trainload freight businesses
	High valuation of Mexican businesses, Conrail	**Low valuation of UK trainload freight businesses (even after consolidation)**

Now, remember that this is a presentation that was given five years ago. What do we have here? (Table 7) “Capacity constraints”; does that sound familiar? And also cannibalization of business between operators. The one example that I gave you earlier was Freightliner, the container company going into the coal business, and now you see all kinds of competition in the Dynamic Thrusting Private Sector ballast train business. This is a Pandora’s Box which has not only been pried open, but the lid has been broken off and thrown away.

Table 7

	EXCLUSIVE FRANCHISE	OPEN ACCESS
TRANSPORTATION MARKETS	Increase in Latin American traffic	Decline in European traffic
	Return of Southern Africa’s international flows	Growth in European river transportation (containers)
	Renegotiation of franchise terms (Latin America)	**Capacity constraints on freight growth (UK)**
	Penetration of eastern coal markets by western coal (USA)	**Cannibalization of EWS coal flows by Freightliner (UK)**

Table 8 is slightly different in that it repeats the theme that Open Access is driven by politics. It does acknowledge that there is some consideration for the customer, but notice that there is no consideration for the carrier which is, to say the least, unfortunate.

Table 8

	EXCLUSIVE FRANCHISE	OPEN ACCESS
PRIMARY FOCUS	CUSTOMER	**POLITICAL**
SECONDARY FOCUS	INVESTOR	**CUSTOMER**
OPERATIONAL CONTROL	OWNER	REGULATOR
INVESTMENT IN INFRASTRUCTURE	YES	NO

I argued then and would argue even more strongly today that the financial and transportation markets have repudiated the Open Access model if only because nobody has figured out a way to pay for it. Certainly it has sucked most of the value out of the businesses and, as Ed pointed out, handed it on a silver platter to customers who otherwise would have used rail anyway.

2005 Open-Access Failure in the UK

Assoc. of Transportation Law Professionals Newsletter

Finally, I would like to share with you a brief write-up that I did for the Association of Transportation Law Professionals newsletter last year. The title is blunt, which is “Open-Access Failure in the UK”. I don’t mean to pick on the UK but it is so easy because there is so much data and there is really a common thread with North America; and also there is so much investigative journalistic thinking that goes on here.

In particular, I reviewed my conclusions with many more knowledgeable than myself, including Roger Ford, the very journalist who coined the theme “Dynamic Thrusting Private Sector Management”. And for those of you who think you are knowledgeable about Europe, if you don’t subscribe to *Modern Railways* magazine, you are not really as knowledgeable as you could be. They have a pervasive culture of investigative journalism, partially because there are enough people in their country to support a magazine that doesn’t rely on advertising and doesn’t have to worry about offending anybody. I cannot recommend *Modern Railways* enough.

But the reason that I did this particular article was because I am a regular receiver of the UK’s Rail Freight Group’s newsletter. They had a news item that read as follows: “Huge rise in freight moved by rail.” It talks about a 60% growth in net ton kilometers. Is this not an example of “Dynamic Thrusting Private Sector Management” and the Vigor of the Marketplace Unleashed and Pried from the Dead Hand of the State? If you look at Table 9, what they are talking about is net ton kilometers and the impressive growth in net ton-kilometers. I must agree that this is truly impressive.

Table 9

Net Ton-Kilometers (billions)

	TOTAL	COAL
1995 – 1996	13.3	3.6
2004 – 2005	20.7	7.0

But if you look at Table 10 at tons as opposed to ton-kilometers, keep in mind that ton-km. are driven by length of haul. What is most telling is the non-coal business and what happened to it in the same period. The originations of non-coal traffic actually dropped 10% since the introduction of “Dynamic Thrusting Private Sector Management” to the UK rail network.

Table 10

Net Tons (millions)

	TOTAL	COAL	OTHER
1995 – 1996	100.7	45.2	55.5
2004 – 2005	101.9	51.7	50.2

So the driver of growth was the collapse of the domestic coal industry and, in fact, for non-coal traffic, capacity constraints have prevented the capture of non-coal business, and pervasive on-rail competition has constrained it to a certain extent. Why would you want to attract some new business to rail when after a year or so your customers could go to somebody else and get the same deal but cheaper? It's just not worth it.

And finally, the funding mechanism for increased capacity is limited to a very reluctant public sector. If you look at the arguments for the Rail Freight Group's existence, it is largely founded on the benefits to society of reduced congestion and reduced fuel consumption. And so I would suspect that many of the reasons that the Rail Freight Group exists is to promote the soft benefits of rail which are not recognized in a pure market environment. In fact, the philosophy of the Rail Freight Group seems that if there is a rail freight operator that is making a profit, it must be because somehow they are exploiting the system and need to have even more competition.

Conclusions

Let me draw some conclusions that apply today. Everything I just presented was written from a year to 11 years ago. First of all it is about transferring value from a rail franchise to rail customers, meaning that Open Access results in almost a dollar-to-dollar transfer from rail carriers into the pockets of rail customers. In some cases like Estonia, it is a confiscation of value. If re-regulation or similar changes occur in the U.S., that would in economic terms represent a confiscation of value and punishment for having survived the restructuring in our country and for having become what we are today. It would be shame to see that happen.

But let's look at the nuts and bolts; the conclusions are easily translatable from Europe to North America as to why this is going to be a big problem for all of us, and that is the fundamental disconnect between infrastructure and operations. You can never get railway people to agree as to what is the exact, perfect, appropriate infrastructure for railroads sharing the same infrastructure. Look at the disagreements just between Amtrak and the freight railroads, let alone freight railroads exercising trackage rights over each other. Imagine what would happen if you had a government agency in the middle of those discussions.

Further, the costs of administration are extremely complicated and expensive to administer even if you are just getting along as opposed to disagreeing. And finally, consider the lack of responsive funding mechanisms. When you give all the money to the customer, it doesn't matter whether you are the operator or the infrastructure company; who is going to pay for this?

We are The Lexington Group in Transportation History and I think we have something of value to offer this country which is more than a little bit of perspective; we can look overseas for examples. It never ceases to surprise me when I run into people in the public sector who aren't aware that there are other continents out there. The classic example was meeting somebody from Homeland Security who was talking about security on buses and putting metal detectors on school buses. My question was, "Have you ever talked to the Israelis? They have some security issues in their country as I think those of you who read newspapers may have noticed.” It apparently had never occurred to them.

So again, the value of what we do in this organization is to look back to history and find value in other people’s experience. I think we can do a great service to this country by reminding people of many very expensive experiences. And it has certainly been expensive for Ed and me because we are both investors in a country which has retroactively turned into a punitive Open Access environment.

A final point: I have just made some economic arguments, but I would argue that the most fundamental economic force which has emerged in the last several years is “the marketplace for legislation” vs. “the marketplace of ideas”. Of course we don’t have corruption in this country; it’s called “influence”. But these same forces are at work here that we see elsewhere. The fact is that railroads are more valuable now because commodity prices are up and the delivered cost of a more valuable lump of coal enjoys a higher price, which can either be used to pay transportation bills or to buy legislation. Again, I’m not saying that we have corruption in this country (I love freedom!), but we do have Influence. What we see in other countries as corruption is what is going on today in this country under the name of Influence. So (and I hate to use this word at a railroad conference) it’s a Paradigm Shift!

At any rate, Open Access advocates should be very careful what they ask for because they just might get it.

Thank you and have a safe day.

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