

Rail Earnings Today Pay For Capacity and Service Improvements For Tomorrow

ASSOCIATION OF AMERICAN RAILROADS

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Summary

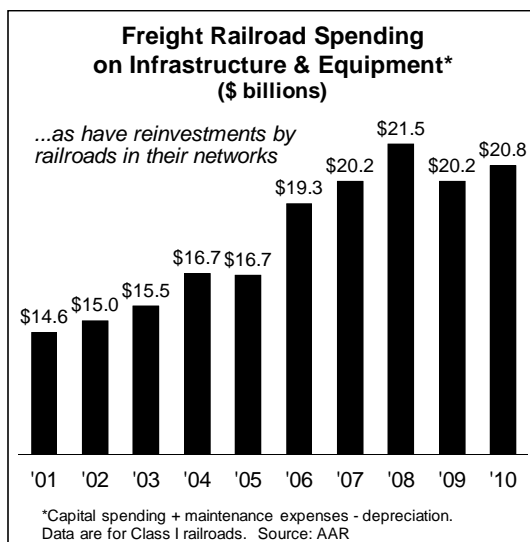
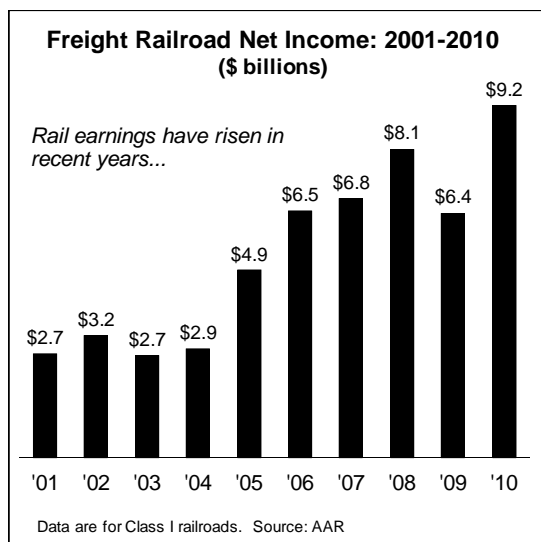
Prior to the Staggers Rail Act of 1980, America's railroads were on the brink of ruin. Railroads could not afford to properly maintain or upgrade their tracks and could not provide the reliable, cost-effective service that America's shippers and consumers needed and deserved. Since Staggers, though, railroads have been reborn. Average rail rates have fallen 51 percent (measured by inflation-adjusted revenue per ton-mile), accident rates are down 77 percent, rail service is vastly better, and rail traffic has nearly doubled. Rail earnings have also improved, allowing railroads to reinvest \$480 billion back into their systems to create a freight rail network that is the envy of the world.

The Need for Continued Rail Investments

Until the recession, America's railroads were carrying more freight than ever before. In recent years, their earnings have improved as well. But that's only part of the story.

Unlike trucks, barges, and airlines, which travel on highways, waterways, and airways that the government provides and pays for, **America's freight railroads operate almost exclusively on infrastructure that they own, build, maintain, and pay for themselves.**

In fact, from 1980 to 2010, freight railroads reinvested approximately **\$480 billion** of their own funds on locomotives, freight cars, tracks, bridges, tunnels and other infrastructure and equipment. That's more than **40 cents out of every revenue dollar**, invested right back into the rail network that helps keep our economy running.



Rail traffic fell sharply during the recent economic downturn, but experts agree that over the long term, freight transportation demand will surge and new rail capacity will be needed. Recent forecasts reported by the Federal Highway Administration, for example, found that total freight movements across modes will rise from an estimated 16.9 billion tons in 2010 to 27.1 billion tons in 2040 — a 61 percent increase.

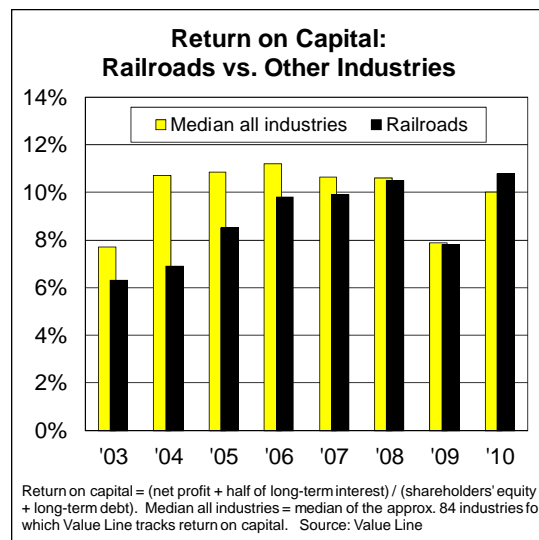
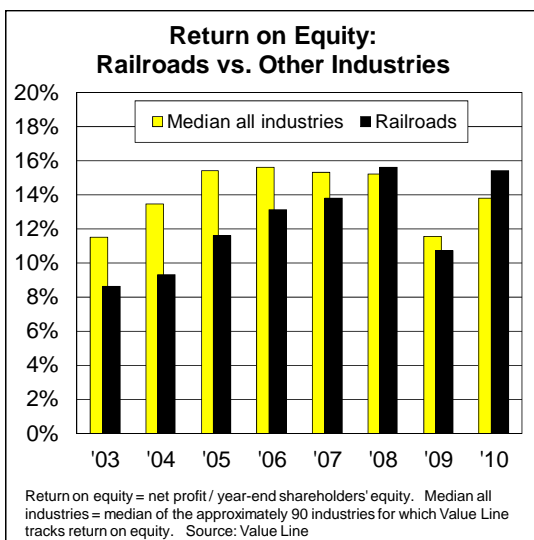
That’s why **improved rail earnings in recent years are a positive development**. They allow railroads to more readily justify and afford the massive investments that are needed to keep their track and equipment in top condition, improve service, and add the new rail capacity that America will need in the years ahead. As the Congressional Budget Office noted in a 2006 report, “As demand increases, the railroads’ ability to generate profits from which to finance new investments will be critical. Profits are key to increasing capacity because they provide both the incentives and the means to make new investments.”

Even “Record” Rail Earnings Are Only About Average Among All Industries

Rail industry profitability has historically lagged most other industries. Even in recent years, when rail critics have been decrying “record railroad profits,” rail earnings have generally been no better than average among all industries.

Return on equity (ROE) is a common profitability measure. Based on data from Value Line (an investment research company), the ROE for the rail industry rose from 8.6 percent in 2003 to 15.6 percent in 2008, fell to 10.7 percent in 2009, then rose again in 2010 to 15.4 percent. From 2003 through 2007, rail industry ROE was less than the median of all industries, generally substantially so. Only in 2008 and again in 2010 was rail industry ROE higher than the median ROE of all industries (see chart below left) — probably the first time ever that this happened. Return on total capital is another way Value Line measures profitability across industries. By this measure too railroads in recent years have generally been no better than average among all industries (see chart below right).

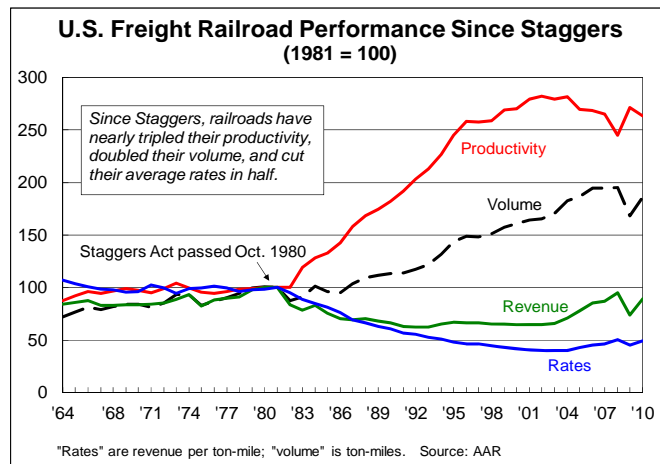
What does this mean? Recent years have perhaps been the best financial years ever for railroads. Even so, their financial returns during these years have been only average or slightly higher than average among all industries. These results are clearly not indicative of an industry that is earning excessive profits.



Some rail critics have claimed that because railroad “profit margins” (net income divided by revenue) are higher than most other industries, rail profitability is excessive. These critics ignore the fact that because firms in different industries have vastly different operating characteristics and very different quantities of assets required to generate their profits, profit margin is virtually worthless for comparing profitability across industries. For their part, railroads require an enormous asset base (tracks, locomotives, signals, terminals, bridges, tunnels, etc.) in order to earn a given amount of revenue, and they must be able to earn enough to pay the huge costs of these assets.

Keep Reasonable Regulation

Prior to 1980, Americans could not obtain efficient, reliable freight rail service because railroads were being strangled by excessive regulation. More than 20 percent of rail mileage was owned by **bankrupt railroads**, **safety was deteriorating**, and **rail tracks and equipment were literally falling apart** because railroads couldn’t afford the repairs. Then, in 1980, Congress passed the Staggers Rail Act. Thanks to the **balanced regulation** instituted by the Staggers Act, America’s freight railroads are now the **most productive and affordable** in the world.



Unfortunately, some have seized upon railroads’ improved financial performance to support their claims that the government should once again over-regulate the railroads. (Some of these same groups have been calling for more rail regulation for many years, including when railroads had virtually no profits at all.)

The view that an increase in rail profitability to moderate levels justifies **reinstating excessive regulation on railroads is wrong and shortsighted.**

New heavy-handed regulation would send railroads back down the wrong track — **away** from financial sustainability. It would force railroads to lower their rates to certain favored shippers to below-market levels at the expense of other shippers, rail employees, and the public at large. **Several billion dollars** in rail revenue could be lost each year.

Going back to a stifling regulatory environment would artificially cut rail earnings and **severely harm railroads’ ability to reinvest in their networks**, thereby threatening railroads’ ability to provide the safe, affordable, and environmentally responsible service that America needs. Freight that otherwise would move by rail would move on the highways instead — meaning more highway gridlock, more greenhouse gas emissions, and, ultimately, higher costs for the general public.

