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"It is futile for small railroads to attempt to obtain waiver of paper barriers in arbitration under the Railway Industry Agreement" – Albany & Eastern Railroad, Comments in Support of Renewed Petition for Rulemaking, *Ex Parte* 575, March 8, 2006

Paper Barriers and Mercantilism appear to have much in common. Paper Barriers[1] limit a short line's commodity-OD Pair routing options while Mercantilism limits a colony's export of goods to "protect business interests against foreign competition."[2] It has been argued that the practice of mercantilism and the payments extracted from the North American colonies by the British Government in the 18th Century were at least partly responsible for the American Revolution. And the present STB hearings on *Ex Parte* 575 indicate yet another revolution may be afoot.

As to the first, "The grumbling of discontent…reached a crescendo in the 1760s and 1770s when the onerous side of Britain's colonial and monetary policies became blazingly obvious. In the 18th century most British policymakers and political economists were so-called mercantilists, not free traders. They thought it necessary to control trading routes in order to ensure a steady flow of raw materials to the British Isles. British policies where therefore designed to prevent Americans from controlling their own trading routes and money supplies."[3]

The common ground is the fact that both shortlines and the colonies were set up as business enterprises sponsored by and designed to enrich other, larger entities. "The hope was that colonists, like dutiful sons, would create economic value out of the wilderness, keep a small portion to reproduce themselves, and remit the balance to the mother country to pay for taxes, interest, insurance and British manufactured goods."[4]

Fast forward to the present and get this: "The hope was that shortliners, like dutiful sons, would create economic value out of poorly-performing rail segments, keep a small portion to reproduce themselves, and remit the balance to the sponsoring Class I (the "mother country") to pay for equipment and administration."

In the 1700s successful colonists could "buy a property for 100 Florin and find 1000 florin in natural resources on it."[5] Unfortunately the rules of the game – increasing payments to the mother ship – diminished the initial return on investment and thus the value of the enterprise to any would-be purchaser. That, plus the limits on what the entrepreneur could get paid for his resource-development efforts, made the colonists eager to gain control over their own economic fortunes by shedding the limits of the mercantile system.

Now see the parallel with the short lines' dilemma over paper barriers, especially with regard to "new business." Just as the 18th century colonist recognized the obligation to support the mother ship with what returns he inherited with his bit of earth, so do shortliners recognize the value of the inherited franchise. It's only reasonable that commodity O-D pairs of traffic on the property at the time of purchase remain with the sponsoring Class I. But what happens when the entrepreneur develops resources that want to move in lanes other than the ones that went with the deal?

In a filing dated 3/21/2005 the Western Coal Traffic League (WCTL) said that there have been significant changes in STB policy since the signing of the RIA and that "given the benefit of experience unreasonable paper barriers should be subject to challenge." After nearly a year's worth of back and forth the STB on 2/1/2006 issued a decision to request "comments on the renewed petition of the WCTL) for a rulemaking to address agreements to sell or lease a rail line that restrict the ability of the purchaser or tenant to interchange traffic with competitors of the seller or landlord railroad."[6]

The responses thus far, from the A&E's (above) to the ASLRRA and its Railway Industry Working Group, give one a good look at some opportunities to strengthen the competitive position of rail service. If the energy spent on protecting the mother ship franchise went instead to developing viable commercial products we'd all be a lot better off. Just as mercantilism imploded under its own weight so will "unreasonable paper barriers" eventually cause the demise of the very traffic they were designed to protect.

So if some paper barriers are "unreasonable," are any "reasonable" paper barriers? Absolutely, especially where significant revenue streams are involved but where the asset-cost of maintaining the infrastructure producing those revenue streams don't meet the Class I's internal hurdle rates. BNSF leased the Carlsbad line to the Southwestern Railroad yet still provides power and equipment for the potash unit trains. CSX leased the WV coal routes to Watco's Appalachia & Ohio precisely to feed utilities local to CSX. So it becomes a matter of scale.

The ASLRRA correctly states in its EP 575 Comment: "Anything that takes *money* [read *high-yield traffic,* emphasis added] away from the Class I, and thereby makes our business less competitive and shifts that money to short lines, is not in the long run good. That might surprise you, but unless our joint product with the Class I succeeds competitively, we're going to fail. So we don't want artificially to take money from the Class Is and transfer [the money] to the short lines or the shippers, because it will make the product less competitive and that is not good."

Moreover, the Railway Industry Working Group has worked as intended, as demonstrated by this quote from the RIWG's EP 575 filing: "The RIWG's experience under this process indicates that there is a relatively small number of paper barrier issues that have arisen between Class I and smaller railroads.

"For example, the Class I railroads have reported that since 2002 to date, there have been only approximately 75 requests submitted by smaller railroads for relief under the provisions of the RIA (both for paper barrier waivers as well as for all other types of relief available under the RIA); and in that period, approximately 60 requests for waiver or other relief had been granted. In most of the remaining cases, it was either determined that the RIA does not apply to the facts involved or the matter was resolved in some other manner."

My point is there are paper barriers and PAPER BARRIERS. The former cover shortline opportunities incidental to the core values of the original Class I and don't meet yield thresholds anyway. The latter occur when there are revenue streams – new *or* old – the absence of which would clearly denigrate the original Class I's competitive position, i.e., "do harm to" that RR.

It's time to draw a line and make some decisions lest the mercantile aspects of paper barriers cause unintended results. For example, what happens when a shortline with a paper barrier loses a boxcar customer only to find the goods are now riding the primary Class I connection's intermodal trains? Can the shortline try to shift this back to carload via a second Class I connection? Or what if the goods move to a transload on the competing class I because the original Class I's rates are too high? It would be instructive to see if the first Class I would be willing to waive a paper barrier in this case.

In sum, selling Class Is reasonably wanted to protect the revenue stream and priced the transaction accordingly. A short line owner wishing to change the terms of the original transaction must be prepared to renegotiate the deal and pay a premium "to buy his freedom," as senior one Class I manager puts it. The 18th century colonists bought their freedom with an armed revolution. I don't think we need go that far, especially if Class Is are willing to renegotiate the deal in exchange for a purchase price premium. But look for line *sales* to slow or cease until there is a better understanding.

Montreal, Maine & Atlantic Railway has appointed John W. Schultz as VP Transportation, effective March 13, 2006, at the railway's headquarters in Hermon, Schultz has more than 30 years of railroad experience, most recently as director Transportation Services for the UP at Denver, Colo. He previously held a similar post with the UP at Cheyenne, Wyo. from 1994 to 2004. Mr. Schultz holds a BS in Business Administration from the University of Wisconsin, La Crosse.

He began his railroad career in 1970 while still in high school and college working as a section laborer, clerk and switchman for the former Milwaukee Road. He was a lieutenant in the U.S. Army Corps of Engineers for two years prior to joining the Missouri Pacific at Kansas City, Mo., serving as assistant trainmaster and trainmaster. He was promoted to manager Yard/Industry Operations at San Antonio, Texas in 1987 and became manager Transportation Planning at Omaha in 1990.

Taking the other side of the DM&E coal story, fellow pundit Larry Kaufman writes, "If the expansion of DM&E is economically feasible, why isn't Kevin able to get private capital for it? With the repeal of the Public Utility Holding Company Act, there is no reason why the utilities that want cheaper coal couldn't guarantee the line's construction, getting cheaper coal and a share of DM&E profits. And, if the project is *not* economically viable, what is the FRA doing even considering loaning $2.5 billion of taxpayer money to DM&E? If it fails, we taxpayers will end up owning a railroad we didn't bargain for.

"As for the WSJ and others, the UP and BNSF track record is clear. They are expanding coal capacity and have steadily increased their volume. Both are able to fund their capex projects. Neither is asking to tap into the RRIF at the federal till. I suspect that the real value of DM&E to the utilities is the threat that it might get built, presumably forcing UP and BNSF to sharpen their pencils in rate and contract negotiations out of fear. I don't think either really is afraid."

BNSF hosted a press ride this week to show off the capacity improvements between KC and Belen. Velocity is clearly the name of the game for BNSF and the emphasis permeates everthing they do, from negotiating property transfers to profit sharing for agreement personnel. Watch this space and www.rblanchard.com for details.

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[1] See Railroad Industry Agreement, AAR and ASLRRA, 9/10/1998 as amended
[2] LaHaye, Laura, "Mercantilism," The Concise Encyclopedia of Economics, www.econolib.org
[3] Wright, Robert F., *The First Wall Street*, University of Chicago Press, © 2005, p. 30
[4] Ibid, p..29
[5] Ibid, p. 29
[6] STB Decision 2/1/2006, EP 575