Presentation Outline

1. A Short Review of Railroad Regulation
2. The Staggers Act
3. The ICC Termination Act of 1995
4. Reregulation Proposals
5. Analysis and Conclusions
A Short Review of Railroad Regulation

- Original Railroads Were Extremely Profitable
- Profits Encouraged Construction of More Railroads—Financed by Debt
- Rates (and Profitability) Declined Steadily after 1870
- Panic of 1873 and Strike of 1877
  - Railroad Progress Stalled
A Short Review of Railroad Regulation

- Efforts at Self-Regulation
  - The Iowa Pool (1870)
  - Southern Railway & Steamship Assn. (1875)
  - Southwestern Railway Assn. (1876)

- Most of these pools failed due to cheating
A Short Review of Railroad Regulation

- Eastern trunk lines’ efforts to regulate rates never succeeded due to refusal of new competitors to cooperate.
- Rebate demands from large shippers threatened to destabilize the entire system.
  - Railroads looked to federal regulation largely to protect themselves from these shippers.
A Short Review of Railroad Regulation

- Federal Regulation Efforts
  - 1st bill introduced in 1876
  - Supported by commercial interests opposed to rebates and attempting to retain perceived rate advantages
  - Railroads decided to support legislation to save their investment and avoid more onerous state regulation
A Short Review of Railroad Regulation

- The Interstate Commerce Act (1887)
  - Created Interstate Commerce Commission
  - Tariffs had to be filed with ICC
  - Rates must be “reasonable and just”
  - Long and short-haul rate discrimination outlawed
  - Rebates outlawed

- Weaknesses of Act
  - Law was vague and unenforceable
  - No power to set rates
A Short Review of Railroad Regulation

- Depression of 1893
  - 78,000 miles of line foreclosed 1893-98
  - Average rate declined 22% from 1890 to 1900
  - Rebating continued

- Sherman Anti-trust Act (1890)
  - Supreme Court determines pools violate the Act (1897)
  - Legislative efforts to legalize railroad rate pools fail
A Short Review of Railroad Regulation

- **Elkins Act (1903)**
  - Made rebates a criminal offense

- **Hepburn Act (1906)**
  - Empowered ICC to determine “just, fair and reasonable rates” and prescribe accounting system
  - Enacted commodities clause

- **Mann-Elkins Act (1910)**
  - Gave ICC regulatory authority over telephone service
  - Authorized suspension of proposed rate increases pending investigation
  - Shifted burden of proving rate reasonableness to carriers
  - Created Commerce Court (abolished 1913)
A Short Review of Railroad Regulation

- Federal Possession and Control Act (1917)/Railway Control Act (1918)
  - Placed railroads under control of the Federal Government
  - Impetus for elimination of duplicate facilities and services (peak mileage 254,000 (1916))
  - Operations were extremely unprofitable despite rate increases

- Transportation Act of 1920
  - Returned railroads to private control
  - Exempted railroads from Clayton Act
  - Authorized ICC to approve and regulate pooling
A Short Review of Railroad Regulation

- Transportation Act of 1920 (cont’d)
  - Provided for valuation of railroads and rate levels intended to generate 5 ½-6% return on investment
    - ICC authorized to set minimum rates
  - Gave ICC jurisdiction over mergers, line construction, line abandonment, issuance of securities
  - Directed ICC “to prepare and adopt a plan for consolidation . . . into a limited number of systems”
A Short Review of Railroad Regulation

- Filed Rate Doctrine (*Keough v. C&NW*, 1922)—foreclosed antitrust challenges to rates found reasonable by ICC

- Railroad Consolidation Plans
  - Railroads could not agree on details
  - Effort abandoned during the Depression

- Depression substantially reduced traffic
  - About one-third of operators bankrupt by 1937
  - Emergency Railroad Transportation Act (1933)
A Short Review of Railroad Regulation

- **Motor Carrier Act of 1935**
  - ICC gained jurisdiction over motor carrier market entry and tariffs

- **Transportation Act of 1940**
  - Gave ICC jurisdiction over water carriers
  - Formally withdrew consolidation mandate

- **Reed-Bulwinkle Act (1948)**
  - Exempted rate bureaus from Sherman Act

- **Transportation Act of 1958**
  - Authorized ICC to approve passenger service discontinuance notwithstanding state regulatory action
A Short Review of Railroad Regulation

- Procedural issues stifled railroad rate innovation in the 1960s
  - SR “Big John” hopper case
  - IC “Rent a Train” case
  - Car service requirements
- Railroads were unable to recover cost increases as they were incurred in an inflationary environment
- Interstate Highway System increased motor carrier productivity
A Short Review of Railroad Regulation

- Abandonments could not be effected without protracted proceedings
- Passenger and commuter train losses debilitated railroads
  - Rail Passenger Service Act (1970)—created Amtrak
  - Local authorities slowly bought or began subsidizing commuter operations
- Maintenance was deferred, reducing efficiency and increasing derailments
- Result: bankruptcies
  - Penn Central (1970)
  - Rock Island (1975)
  - Milwaukee Road (1977)
A Short Review of Railroad Regulation

- **Regional Rail Reorganization Act (1973)**
  - Created Conrail

- **Railroad Revitalization and Regulatory Reform Act (1976)**
  - Required finding of “market dominance” (“absence of effective competition”) to challenge rates
  - Commenced changes in costing
  - Provided for regulatory exemptions
    - Perishables and unprocessed agricultural commodities
  - Optional time limits for merger proceedings
  - Appropriated funds for capital investment

- **MRRA (1979) and RITA (1980)**
The Staggers Act

- **Background**
  - Conrail was highly unprofitable
  - Milwaukee and Rock Island bankrupt
  - Overall industry rate of return was 1% in 1978 (cost of capital 10.6%)
  - Significant overcapacity
  - Lightly-utilized branch lines in poor condition
  - Stagnant traffic and declining market share
  - Rate regulation seen as key impediment to profitability
The Staggers Act

- Became effective October 1, 1980
- Key provisions
  - Sets revenue adequacy as regulatory policy
  - Limited rate regulation
    - ICC has jurisdiction to consider reasonableness of rate only if railroad has market dominance
    - If rate is < 180% of variable cost, railroad does not have market dominance
    - Shipper has burden of proving market dominance
The Staggers Act

- Confidential transportation contracts legalized
- Exemptions mandated where regulation is not necessary to promote transportation policy, and transaction is of limited scope and regulation not necessary to protect shippers from market power
- Merger standards revised to promote consolidation
- Time limits imposed on merger and abandonment proceedings
- Rate bureau activity constricted
The Staggers Act

- **Companion Legislation**
  - Motor Carrier Act of 1980
  - Northeast Rail Service Act (1981)
    - Rationalization of Conrail
    - Transfer of commuter service

- **Results 1980-1995**
  - Significant segments of railroad traffic exempted from regulation
    - Intermodal
    - Boxcars
  - Substantial proportion of traffic moved under contracts
  - Many joint rates/routes eliminated
Results 1980-1995 (cont’d)

- Major railroads reduced to “Super Seven” plus C&NW, KCS, IC, Guilford, FEC
- Conrail privatized (1987)
- Powder River Basin coal traffic soars following C&NW/UP entry into Basin (1984)
- Introduction of double-stack equipment promotes profitability of intermodal service
The Staggers Act

- Results 1980-1995 (cont’d)
  - Total railroad mileage declines approx. 32,000 due to abandonments
  - Short line/“regional railroad” spinoffs reduce Class 1 mileage
  - The average rate level declines, but rates on specific traffic increase
    - Affected traffic generally cannot be shifted to truck or barge and has no rail competitive alternative
  - Railroads accelerate productivity improvements to maintain profitability
The Staggers Act

- Captive shippers lobby for changes in the Staggers Act
  - CURE (Consumers United for Rail Equity) formed (1983)
    - Make rate reasonableness proceedings simpler
    - Provide more procedural safeguards in abandonment cases

- Reregulation Proposals
  - Rockefeller bill (rate relief)
  - DeConcini-Seiberling bills (open access refereed by federal courts)

- Senate Committee fails to report out reform legislation by one vote (1988)
ICC Termination Act of 1995

- Resulted from truck undercharge phenomenon
- Negotiated Rates Act of 1993
- Congressional proposals to abolish ICC and eliminate its budget
- Clinton Administration backs termination of ICC
ICC Termination Act of 1995

- ICC abolished effective December 31, 1995
- STB created on January 1, 1996
  - Independent agency within DOT
  - Former ICC Commissioners were first three board members
  - Budget appropriated for three years
ICC Termination Act of 1995

- Changes in Railroad Rate Regulation
  - Eliminated tariff filing requirement
  - Eliminated authority to establish minimum rates
  - Eliminated authority to investigate and suspend rates
  - Repealed Elkins Act prohibition against rebates
ICC Termination Act of 1995

- Changes in Railroad Rate Regulation (cont’d)
  - Recognized stand-alone cost methodology as standard in rate reasonableness cases
    - Simplified procedure for smaller cases to be developed in one year (it was, but it’s rarely used)
  - Imposed time limits for rate and exemption cases
  - Repealed commodities clause and valuation provisions
ICC Termination Act of 1995

- “Bottleneck” Cases
ICC Termination Act of 1995

“Bottleneck” cases (cont’d)

- Shipper routes traffic from origin to destination on one railroad
- Shipper obtains rate from competing carrier to junction near destination
- Shipper wants incumbent railroad to quote rate on terminal, or “bottleneck,” segment from junction to destination
  - Rate could be challenged if > 180% of variable cost or stand-alone cost
- STB: “Bottleneck” carrier is not required to quote separate rate over terminal segment (Central Power & Light Co. v. Southern Pacific T. Co. (1996))
ICC Termination Act of 1995

- Mergers approved
  - UP-C&NW (1995, by ICC)
  - BN-Santa Fe (1995, by ICC)
  - UP-SP (1996)
  - Conrail split-up (CSX and NS) (1999)
  - CN Expansion
    - IC (1999)
    - WC (2001)
    - GLT (2004)
  - KCS-TFM (1996-2004)
ICC Termination Act of 1995

- Severe postmerger operating disruptions
  - UP-C&NW (1995)
  - UP-SP (1997-98)
  - Conrail (1999-2001)
- CN-BNSF merger proposal blocked (2000)
- New, more restrictive merger rules (2001)
ICC Termination Act of 1995

- Results
  - Class I network in U.S. reduced to 97,500 route miles (out of 140,800 total)
  - Freight traffic (U.S. ton-miles) increased 57% 1990-2005
  - Rates declined through 2000 by most measures, then increased
  - Substantial improvement in Class I profitability in 2005-06
Reregulation Proposals

The Problem—Captive Shippers Miss Out on Deregulation’s Benefits

- Examples (from C.U.R.E.)
  - Laramie River Station, WY—Upon expiration of 20-year transportation contract in 2004, BNSF imposed tariff rate doubling freight costs (> 400% rate/variable cost ratio, 175-mile haul).
  - Total Petrochemical (Carville, LA)—Plant solely served by CN; rate to New Orleans (81 miles) is $1,000. By contrast, rate from Laporte, TX to New Orleans (405 miles, BNSF and UP compete) is $1,234.
Reregulation Proposals

- Lafayette Utilities System (Boyce, LA)—UP refuses to quote rate on 20-mile bottleneck segment, precluding competitive BNSF-KCS service. $60 million “build-out” to KCS is cost-prohibitive.

- Entergy Arkansas, Inc. (near Newark, Ark.)—Plant is served by UP and M&NA (UP spinoff). M&NA runs from plant to Kansas City and theoretically could receive Powder River Basin coal from BNSF there, creating a competitive alternative. However, UP’s lease to M&NA imposes sharply increasing rent if M&NA fails to interchange 95% of traffic with UP, creating a “paper barrier.”
Reregulation Proposals

- Arizona Electric Power Cooperative (Tucson, AZ)—Cost of unresolved coal rate challenge at STB exceeds $3 million and has taken four years (vs. 16-month procedural deadline)

  - GAO Analysis (June 2006)
    - Total U.S. rail traffic moving on rates > 180% of variable cost = 31%
    - Total U.S. rail traffic moving on rates > 300% of variable cost = 6%
      - Concentrated in specific geographic areas (e.g., Montana grain, West Virginia coal)
Reregulation Proposals

- Pending Bills
  - Senate
    - Both bills are in the Senate Commerce, Science and Transportation Committee
Reregulation Proposals

- Pending Bills
  - House
    - Bill is in the House Transportation and Infrastructure Committee, Subcommittee on Railroads
Reregulation Proposals

- **Issue:** Bottleneck Rates
  - **Proposed Response:** Mandate rate-setting requirement
    - **H.R. 2047:** “Upon the request of a shipper, a rail carrier shall establish a rate for transportation and provide service requested by the shipper between any two points on the system of that carrier where traffic originates, terminates, or may reasonably be interchanged.”
Reregulation Proposals

- **Issue:** Paper Barriers
  - Proposed Response: Prohibit them
    - H.R. 2047: “The Board may not . . . [approve or exempt] . . . a transfer of interest in a line of railroad, from a Class I rail carrier to a Class II or a Class III rail carrier, if the activity directly or indirectly would result in– (A) a restriction of the ability of the Class II or Class III rail carrier to interchange traffic with other carriers; or (B) a restriction of competition between or among rail carriers in the region affected by the activity in a manner or to an extent that would violate antitrust laws of the United States . . .”
    - Transfers up to 10 years old could be challenged retroactively
Reregulation Proposals

- **Issue:** Competitive Access
  - Proposed Response: Mandated Reciprocal Switching
    - S.919: In 49 U.S.C. §11102(c), change “may” to “shall” require reciprocal switching arrangements and add “In making any finding for the purposes of the first sentence of paragraph (1), the Board may not require that there be evidence of anticompetitive conduct by a rail carrier from which access is sought.” (Would reverse Competitive Access Rules and *Midtec Paper* case)
Reregulation Proposals

- **Issue:** Single-Railroad Domination of Geographic Areas
  - Proposed Response: Designate areas of inadequate rail competition
    - **H.R. 2047:** STB can designate an AIRC when “(1) the State or substantial part of the State encompasses rail shipping origins and destinations that are served exclusively by one Class I railroad;” and (2) pay rates that “exceed the rates necessary to yield recovery by the rail carrier of 180 percent of revenue-variable costs, or have experienced competitive disadvantage in the marketplace or other economic adversity because of high cost or poor quality of rail service . . .”
Reregulation Proposals

• Proposed Response: Designate areas of inadequate rail competition (cont’d)
  - AIRC may be limited to “the facilities of a group of shippers or receivers of one or more specific commodities within a geographic area”
  - STB may impose any of these remedies within an AIRC: (1) reciprocal switching; (2) haulage; (3) “baseball” arbitration; (4) rate review (rates may not be set at < 180% R/VC); (5) expedited review of possible “unreasonable discrimination”
Reregulation Proposals

**Issue:** Rail Rate Challenges Are Too Cumbersome and Expensive

- **Proposed Response:** Arbitration
  - H.R. 2047—At election of either party; S.919—at election of non-carrier only
  - “Baseball” arbitration (imposed rate may not be < 180% R/VC)
  - Effective competition standard: arbitrators may consider rates for comparable movements where competition exists
  - Also, filing fees in conventional rate cases capped at U.S. District Court filing fees
Reregulation Proposals

**Issue:** Rate Reasonableness Determinations Skewed in Railroads’ Favor

- Proposed Response: (H.R. 2047) “The Board shall adopt a method for determining the reasonableness of rail rates based on the railroad's actual costs, including of a portion of fixed costs and an adequate return on debt and equity. The method adopted shall permit a final determination within 9 months after filing a complaint, shall ensure that necessary cost and operational information is available to the complainant, and shall not require excessive litigation costs. The Board shall not use any method for determining the reasonableness of rail rates based on the costs of a hypothetical competitor . . . “
Analysis and Conclusions

What is the purpose of regulation?

- To protect the railroads, or their customers?
- Congress must strike the desired balance between these competing interests
- The public interest should be the determining factor—policies should maximize the public welfare
Analysis and Conclusions

- Public Interest Considerations
  - Promoting industrial, agricultural and mining activity that most efficiently uses society’s resources
  - Promoting modes of transportation that most efficiently move people and products
Analysis and Conclusions

- In general, U.S. regulatory policy is to allow competition to govern the allocation of resources.
- If there is effective competition, there should be no need for government regulation of pricing or service.
- What should happen when there is no effective competition?
Analysis and Conclusions

“Differential Pricing”

- Railroads defend concept on economic grounds: we need to charge higher-than-competitive rates where effective alternatives do not exist to support investment in the railroad system.
- Shippers attack concept on public policy grounds: we should not have to pay higher-than-competitive rates just because we are located in places where no effective alternatives exist.
Analysis and Conclusions

“Differential Pricing”

- Impact of differential pricing, long-term, is to discourage production where no effective competition exists
  - Is demand for the product sufficiently strong to overcome this disadvantage?
  - Put another way, are product alternatives and alternate geographic sources of supply available to consumers?
- But the impacts are probably too long-term to affect railroad pricing decisions
Analysis and Conclusions

**Bottleneck Rates**

- Mergers and regulatory policies after Staggers reduced availability of alternate joint routes.
- If purpose of these policies was to improve financial results of railroads, should they be revisited once that purpose is realized?
- Possible compromise: Require railroads to quote rates on bottleneck segments, but increase the R/VC ratio threshold for review of such rates to ensure railroads are compensated for their stronger competitive position (and additional switching costs).
Analysis and Conclusions

Paper Barriers

- 1980s-90s spinoffs should be recognized as not changing basic Class I-shipper economic relationships
  - Most spinoffs were valued on the assumption that Class I would retain the right to price through traffic originating/terminating on the spinoff
  - Price would have been higher in most cases if Class I were truly “selling the business”
Analysis and Conclusions

- Paper Barriers (cont’d)
  - Purpose of paper barriers was to allow railroad to maintain control of through movement pricing, without creating new competition
  - Prospective prohibition would inhibit railroads’ freedom to sell and/or refinance their assets
  - Retroactive abrogation would raise constitutional takings issues
Analysis and Conclusions

- Competitive Access
  - Is this any different than the bottleneck rate issue?
    - If switching carrier does not serve origins or destinations, presumably it will not attempt to foreclose competition between carriers that do
    - Presumably, shorter distances involved, and build-outs may be a more viable tool for shippers to gain additional competition or rate relief
  - If not, shouldn’t the same resolution apply?
Analysis and Conclusions

- Areas of Inadequate Rail Competition
  - This would create competition where none existed before
  - Regulatory policy is to address above-market rates through rate reasonableness proceedings
    - Rates capped at 180% R/VC not necessarily high enough to achieve revenue adequacy
  - Some proposed remedies (trackage rights) could result in significant operating problems and/or additional costs
Analysis and Conclusions

- Arbitration of Rate Disputes
  - Baseball arbitration has been adopted in another industry context
    - Car hire disputes under deprescription
  - Potential savings in time and cost
  - Possible two-step process
    - STB makes market dominance determination within strict time limits
    - If market dominance is found, case proceeds to baseball arbitration (rate cannot be less than 180% R/VC, except in bottleneck cases)
    - Average industry costs may be used to support final offers
Analysis and Conclusions

- Eliminate Stand-Alone Costing
  - Under baseball arbitration system, parties could use stand-alone costing to support their cases, but would not be required to do so
Conclusion

- Shippers and railroads have been struggling over their relative prosperity for over a hundred years.
- While the struggle won’t end soon, modest statutory reforms should adequately address issues raised by shippers without materially adverse consequences for the railroads.