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The Railroad Competition and Service Improvement Act Why Government-Enforced “Competition” Will Not Work

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The deregulation of freight railroads in the United States, which began in 1976 and culminated in 1980, has brought enormous benefits. The nation’s rail traffic has increased by 90 percent, while accidents have decreased by 68 percent,¹ and rates have decreased throughout most of the country.

Deregulation has allowed economies of scale. Since 1980, the nation’s freight railroads have consolidated into fewer companies. In response, some shippers, especially those with access to only one railroad, seek to reregulate the rail industry to their favor. They claim that consolidated railroads have closed some lines, leading to reduced competition and higher rates. In response to this clamor, the Railroad Competition and Service Improvement Act (RCSIA, H.R. 2125/S. 953), sponsored by Rep. James Oberstar (D-Minn.), seeks to promote consumer advocacy and rate competition—at the cost of ownership rights and greater government involvement in rate setting. This paper looks at how the proposed RCSIA would affect U.S. freight service. It concludes that the RCSIA would hamper this vital industry.

Background: Deregulation and Consolidation. The Railroad Revitalization and Regulatory Reform Act of 1976 (RRRA), combined with the Staggers Rail Act, liberalized federal regulation of the railroad industry. The most important change was railroads being allowed to establish any rate for rail service—unless the Interstate Commerce Commission (ICC) decreed that there was a lack of competition—and to sign contracts with rail shippers without review by the ICC (which was replaced by the Surface Transportation Board (STB) in 1995).² RRRA also outlawed collective rate-setting by groups of railroad operators and ended mandatory industry-wide rate increases.

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Since the Staggers Act, the railroad industry has gone through major consolidations, resulting in 40 Class I railroads³ (or 22 by the Association of American Railroads' account) merging into seven railroads, four of which control 95 percent of traffic. The Association of American Railroads defines Class I railroads as those having above a certain level of revenue, which was \$346.8 million in 2006.⁴ However, some operators have abandoned many segments of rail track or sold them to non-Class I railroads.⁵

What the RCSIA Purports To Do. The Railroad Competition and Service Improvement Act is intended to reregulate the railroad industry.⁶ It would seek to remove competitive market pressures in order to decrease rail rates for a few shippers along routes determined by the Surface Transportation Board to have a low level of competition, due to the low number of railroads operating there. Specifically, the RCSIA would make the following changes to U.S. railroad policy:

- Force a railroad to allow another railroad to provide rate quotes and transport over segments of track with little competition (known as bottleneck segments of track).⁷ This is known as “quote a rate.”
- Disallow the Surface Transportation Board from authorizing the sale of a portion of track by a Class I railroad to a Class II or III (non-Class I) railroad if that transfer would restrict the non-Class I railroad from interchanging traffic with other Class I railroads. This is known as a “paper barrier.”⁸
- Give the STB greater latitude in requiring railroads to interchange traffic by removing the “public interest” requirement it currently must meet in order to force such a change. This is known as “reciprocal switching.” This change would lead to greater competition between railroads, but only through compromising a railroad’s ownership of its tracks.
- Create an Office of Rail Customer Advocacy within the Department of Transportation and enact other “customer rights” provisions, including processes for arbitrating customer rate complaints, reductions in filing fees for petitions, and the transport rate to which rate “reasonableness” complaints are compared.
- Allow either the governor or attorney general of a state or the DOT Rail Customer Advocate to petition the STB for remedies to a perceived lack of rail competition. The STB would then need to respond within 60 days. Remedies may include: expediting rate challenge cases or ordering, requiring reciprocal switching, requiring railroads to provide hauling services for competitors, or final offer arbitration between railroads.

The proposed legislation focuses on areas where only one railroad provides service. However, even in such cases, a railroad in control of a bottleneck does not enjoy a monopoly over transportation—railroads always face competition from truckers and in some cases river barges.

Furthermore, the RCSIA would not any solve rate competition problems within the rail industry and would likely harm the industry by creating rate ceilings and giving the STB greater regulatory power. Savings from transportation rates for producers, shippers, and end consumers may prove illusory when one considers the impact that rate regulation will have on quality of service, timeliness of transport, and other non-monetary shipping

costs. Employing government resources to reorganize rail transportation would use taxpayer dollars to subsidize transport costs for producers in certain areas.

Debate over Railroad Rates. An October 2006 Government Accountability Office (GAO) report found that real railroad rates have “decreased by more than 20 percent from 1985 through 2004,” even as costs to shippers, including “upgrade costs, fuel and surcharges” increased. However, rebates and incentives reduce the transparency of published transportation rates.⁹ The Association of American Railroads claims that inflation-adjusted rates have fallen by more than 50 percent.¹⁰ A Surface Transportation Board study shows that inflation-adjusted U.S. rail rates fell by 45.3 percent between 1984 and 2000.¹¹

However, R.L. Banks and Associates, a transportation industry consultancy, claims that rates have not decreased at all, but that long haul traffic has increased, giving the illusion of reduced rates, calculated as revenue per ton-mile.¹²

Consumers for United Rail Equity¹³ (CURE), an umbrella organization of industrial freight rail customers, claims that 20 to 35 percent of rail freight is subject to captive shipping rates that are 75 percent higher than competitive rail rates. Moreover, notes CURE, some materials either cannot be transported by truck or are barred by law from being moved by truck, so the producers of those goods must move operations to avoid becoming captive shippers.¹⁴ The same GAO report attempts to identify captive shippers by using Bureau of Economic Analysis data to find areas only served by one Class I railroad.¹⁵ (See Table 1).

Table 1. Areas served by 1 Class I railroads.

West	Midwest	East
Southwest Oregon	Northern Nebraska	Western Ohio
Southern Idaho	Southern Missouri	Central Tennessee
Eastern Montana	Northern Arkansas	Southern central Kentucky
The Grand Canyon	Eastern Wisconsin	The Florida Panhandle
The lower fifth of Arizona		Eastern Alabama
Western Texas		Eastern Alabama
Southeast New Mexico		Maine
Northwest Wyoming		Northern Vermont
North and west South Dakota		New Jersey
		Delmarva Peninsula
		Southern North Carolina
		Northeast South Carolina

The STB’s Flawed Methodology. The Surface Transportation Board determines whether a shipper, or group of shippers, is captive if it is charged more than 180 percent of the railroad’s rate over variable cost (R/VC).¹⁶ Variable costs are those costs directly related to production volume, including factors like labor and packaging, and are flexible in the long term. Rate over variable cost is the rate charged divided by variable cost.¹⁷

Under the RCSIA, the maximum a railroad could charge a company found to be a “captive shipper” would be the variable cost of the bottleneck segment.¹⁸

Without the higher rates, it would likely become uneconomical for railroads to provide service along low-demand routes. The ratio that RCSIA uses to identify potentially captive shippers assumes that the variable cost constitutes the *only* cost of providing rail service. That ratio does not include the *fixed* costs of running a railroad, including track materials and maintenance, which represent higher costs per shipper or per tonnage shipped on less-traveled routes. Thus, the higher transport rate charged along bottleneck segments may be considered the cost of having railroad service in those areas.

Transport Alternatives. One criticism of the Staggers Act from shippers is that it has allowed railroads operating a bottleneck portion of track to enjoy a monopoly over that section of track in terms of use and rate setting. Only the government can create a monopoly by prohibiting a company from entering the market. The federal government does this by requiring new rail segments to be approved by the Surface Transportation Board before construction.¹⁹

Rail prices and the location of inputs affect producers farther along the supply chain when input prices increase due to shipping and other related costs. Thus, just as it can avoid rising costs by switching to less expensive suppliers, a company may cut costs in the longer term by moving production to an area with more transportation choices.

No railroad has a monopoly over all forms of transportation. A producer may transport its goods using a variety of other methods, including trucks, barges, planes, ships, and pipelines.

Substantial track-laying costs have kept competition from other railroads along bottleneck segments low. However, any significant increase in demand for rail services along low-demand routes could encourage other railroads to lay their own tracks or develop contracts to share tracks with the incumbent rail companies.

What the RCSIA Would Actually Do. The Railroad Competition and Service Improvement Act has several provisions that would affect Class I railroad service.

“Quote a Rate.” The proposed RCSIA’s Section 102 purports to address the alleged problems of “captive shippers” by allowing shippers to request transport over bottleneck segments from the track owner without having to use the bottleneck operating railroad for the entire trip. Under the Staggers Act, the bottleneck railroad has the option to carry the cargo the full length of the shipper’s route beyond the bottleneck portion of track. Under the RCSIA, railroads would be able to charge a maximum rate over the bottleneck segment of their tracks equal to the variable cost of operation.

However, as noted above, the variable cost-based rates of bottleneck service do not cover the full cost of serving that segment of track.²⁰ Imposing a rate ceiling may make it inefficient to operate the bottleneck. Under those circumstances, shippers may find that

section of track no longer operated by a Class I railroad, since it may be sold to a non-Class I railroad or abandoned.

Paper Barriers. When selling portions of tracks to non-Class I railroads, Class I railroads often include in the contract a provision preventing the purchasing railroad from interchanging traffic with other Class I railroads. This is called a “paper barrier” to interchanging traffic. Often, segments of tracks are sold or lent to non-Class I railroads so that local railroads can provide geographically specialized service, especially in rural and underserved areas. The Class I railroad gets the benefit of increased traffic through cooperation with the non-Class I railroad.²¹

This makes routes that have become unprofitable to maintain under the “quote a rate” system more expensive for sale and less attractive for lease to another railroad. Those engaged in selling and buying railroads may find a way to work other non-monetary benefits into the contract that also restrict competition. If a railroad cannot afford to operate a segment of track but is also unable to sell it, the railroad may end up abandoning it. For shippers, the choice is between market prices combined with market-competitive service or the low level of service the railroad can afford to provide at the regulated level.

Reciprocal Switching. Requiring railroads to interchange each other’s traffic, known as reciprocal switching or “open access,” adds additional costs to operating a railroad. It is not against the nature of railroads to practice reciprocal switching if the benefits outweigh the costs. There has been cooperative switching in the form of mergers in the 28 years since deregulation. Many railroads that found it more efficient to switch each other’s traffic and combine other costs have merged into one company.

Reciprocal switching may also allow railroads to request access to competitors’ tracks without meeting the existing “public interest” requirement. This would compromise a railroad’s ownership of its track. As MIT economist Jerry Hausman notes: “If a competitor faces a ‘make or buy’ decision and a regulatory agency offers the use of an investment at a cost that does not account for the significant uncertainty regarding sunk investments, most companies will decide not to take the risk of investment. Instead they will use their competitor’s network to provide the needed resources.”²²

Customer Advocacy. The RCSIA has several sections devoted to customer advocacy.

- Section 202 requires railroads to provide “reliable and efficient” service.
- Section 203 awards damages to shippers who have suffered due to slow service and delivery.
- Section 204 creates an Office of Rail Customer Advocacy in the Department of Transportation.
- Section 301 says that customers and shippers have the right to file a rate complaint with the STB and addresses accessibility and cost effectiveness for consumers.

- Section 302 reformulates the rate complaint process to make the complaint filing process less expensive for shippers, and places the burden of proof on the railroads to show they have reasonable rates.
- Section 303 lowers the fees charged to file a complaint from \$178,200 to \$500.²³
- Section 304 changes the way railroad disputes are arbitrated. Under the RCSIA, either shipper or railroad may request arbitration, each party selects an arbitrator and the two arbitrators then select a third arbitrator.
- Section 401 allows the STB to investigate under its own initiative and suspend rail activities that it determines “unreasonable” (more than 180 percent of R/VC), affect more than one person, or fall afoul of the law in some other way.

The RCSIA’s customer advocacy provisions make it more difficult for the railroads to balance the costs of providing transportation services with the revenue obtained from traffic against the economically appropriate level of service. This will make it economically impossible for the railroad to run along certain routes. These provisions will encourage shippers to apply political pressure to railroads rather than rely on market forces. And once such policies become law, companies lose a lot of the flexibility that is essential in times of economic change.

Governor Petition. Under the RCSIA, governors may petition the Surface Transportation Board for remedy to underserved areas that are charged rail rates in excess of 180 percent of R/VC. The STB has 60 days to formulate and implement the remedy. The Rail Customer Advocate—within the Department of Transportation—would review the policy’s effectiveness one year after its implementation.

Lower prices for rail transportation will encourage: 1) more shippers to use railroads for transportation; 2) producers and shippers to stay in the underserved area; and 3) others to move in. The railroad, like any rational actor, will move resources away from less profitable activities to the extent possible. These reactions will likely exacerbate a problem of low service availability.

Lessons from Regulatory History. Heavy-handed regulations tend to backfire on the consumers they are intended to help. For example, in the 1970s, gasoline shortages in the wake of the enactment of price controls showed the ineffectiveness of price caps. Instead of providing the quantity of gasoline consumers wanted to buy at a set price, limited quantities were available to consumers who were willing to wait or lucky enough to find it. The fundamental laws of supply and demand are equally relevant for transportation prices. If rates are restricted to a maximum level that is high enough to increase demand and low enough to decrease supply, there will be a decrease in the supply of rail transport at that price and more, frustrated, underserved shippers.

Similarly, rent control in New York City during the mid and late 20th century was created to protect consumers from rising rental costs. The companies and people who owned rent-controlled housing found that they were losing money by providing rental space. Many converted the rental housing for other purposes for which they could charge market rates, while many rental owners simply abandoned the rental market altogether. In sum,

rental space in New York shrank. Few new apartments or rental homes were built, since it was not economical to maintain rental housing.²⁴

The case for new federal rail transport regulations is weak. Such regulations will have few positive affects and many negative repercussions. The RCSIA will impose costs that larger rail companies could likely absorb, while pushing smaller companies that could not afford to comply out of the industry. In this way, government regulation would create a quasi-oligopoly, as the cost of entry into the industry would be much higher than they would be in a free market. The result would be fewer choices and higher costs for shippers—and higher prices for consumers.

Conclusion. The increase in railroad mergers and closure of some rail routes have been prompted by changes in government regulations as well as market pressures.²⁵ Re-regulating railroads will not address the important issue of the costs railroads face in providing services vis-à-vis the price shippers are willing to pay for those services.

The “captive shipper” problem, whereby shippers allegedly face a monopoly or near-monopoly price on rail transportation, does not exist. Shippers have alternatives to shipping by rail, including shipping by truck, by barge if they are close enough to a waterway, or, sometimes, moving production closer to another, more competitive location.

The “quote a rate” system proposed as part of the Railroad Competition and Service Improvement Act will impose price constraints over the bottleneck segments of track around the nation. The RCSIA also creates an obligation to serve shippers and awards damages to shippers who are not given timely service. It may not be possible for railroads to meet these requirements along bottleneck segments without those segments becoming a net drain on revenue. These policies together may lead to more railroad routes being abandoned because sometimes it is more expensive to sell segments than to abandon them (if railroads cannot include non-competition clauses in contracts). The Act’s customer advocacy provisions further create an environment hostile to railroad companies by allowing shippers to file complaints at lower cost while railroads bear the burden of proof.

The RCSIA will not benefit shippers and producers, who will not be able to obtain the service they need at the prices allowed by the regulation. They may file suits regarding timeliness of delivery, but they will eventually find that they need to relocate production to an area better served by various alternative forms of transportation. Rather, the Act will serve as a direct transfer of wealth from taxpayers to producers and shippers, from railroads to shippers, and from some railroads to their competitors.

Notes

¹ “Freight Rail Works for Shippers Reregulation Doesn’t,” Association of American Railroads, http://www.aar.org/IndustryInformation/Re-Regulation/~media/Files/REREG_PDFS/FRW_for_shippers_final.ashx.

² The Surface Transportation Board was created and the Interstate Commerce Commission was disbanded with the Interstate Commerce Commission Termination Act of 1995. Surface Transportation Board website, <http://www.stb.dot.gov/stb/about/overview.html>.

³ Association of American Railroads, "Overview of America's Freight Railroads," http://www.aar.org/IndustryInformation/BackgroundPapers/Economic%20and%20Financial%20Issues/~media/AAR/BackgroundPapers/Overview_of_US_Freight_RRs_Sep2008.ashx.

⁴ "Rail Industry Structure and Market Behavior," Association of American Railroads, February 2008. <http://www.aar.org/IndustryInformation/~media/AAR/BackgroundPapers/145.ashx>, and "Support the Railroad Competition and Service Act of 2007," Action Alert, American Public Power Association, June 2007, <http://www.appanet.org/files/PDFs/2007AA.SupportRailroadCompetition.pdf>. The definition of Class I railroad was changed in 1992 from \$5 million to \$250 million, changing the status of 18 railroads. "Freight Railroads: Preliminary Observations on Rates, Competition, and Capacity Issues," Government Accountability Office, June 21, 2006, page 11, footnote 4. www.gao.gov/cgi-bin/getrpt?GAO-06-898T.

⁵ Non-Class I railroads fall into three categories (as defined by the American Association of Railroads). Regional railroads (typically Class II) have at least 350 miles of track and have between \$25.5 and \$319.3 million (2007) in revenue per year. Local railroads (Class III) have less than \$25.5 million (2007) in revenue per year and perform long distance transportation services called line-hauls. Local railroads are often portions of sold or abandoned Class I track. Switching and terminal railroads switch cars between railroads or from other lines to a common terminal.

⁶ The Act's House sponsor is Rep. James L. Oberstar (D-Minn.); its Senate sponsor is Sen. John D. Rockefeller IV (D-WV).

⁷ Currently, railroads do not share their bottleneck track segments with other railroads so that shippers can receive more competitive service.

⁸ Since 1980, Class I railroads sold off less used portions of their railroads often to regional Class II or III (non-Class I) carriers. As part of the sales contract, non-Class I carriers were restricted from interchanging traffic with any other than the previous Class I track owner.

⁹ Government Accountability Office, *Freight Railroads: Industry Health has Improved, but Concerns about Competition and Capacity Should be Addressed*, GAO-07-94, October 2006, pp. 11-12, 17.

¹⁰ "Destructive Railroad Reregulation," Association of American Railroads, February 2008, <http://www.aar.org/GovernmentAffairs/~media/AAR/PositionPapers/695.ashx>.

¹¹ Surface Transportation Board, Office of Economics, Environmental Analysis and Administration, "Rail Rates Continue Multi-Year Decline," December 2000.

¹² R.L. Banks & Associates, Inc. and Fieldston Company, Inc., "Rail Freight Rates in the Post-Staggers Era," April 1998, pp. 9-10.

¹³ Consumers United for Rail Equity members include the American Public Power Association, Edison Electric Institute, National Rural Electric Cooperative Association, American Forest & Paper Association, American Chemistry Council, and Portland Cement Association, <http://www.railcure.org/index.asp>.

¹⁴ Consumers United for Rail Equity, "The Issue: FAQ." CURE lists items that cannot be shipped by rail as the following: "Coal, agriculture, paper and paper products, logging and construction products, steel and other manufacturing supplies, chemicals, plastics and many other items." http://www.railcure.org/issue/issue_faqs.asp#freight.

¹⁵ GAO, pp. 26-27. When the definition changes to areas where 75 percent or more of freight tonnage has access to less than one Class I railroad, the captive shipper areas include Montana (except the southwest portion) and exclude north Vermont and northern Maine. There is considerable agreement on the definitions of captive shipping areas.

¹⁶ According to the GAO, since 1985, the amount of traffic charged more than 180 percent R/VC has decreased, but the tonnage charged over 300 percent R/VC has more than doubled. GAO, pp 30-32.

¹⁷ A rate equal to variable costs would not include the fixed costs of providing a service or product.

¹⁸ "Proposed Rail Competition and Service Improvement Bills," Soy Transportation Coalition Briefing Paper 07-01, September 2007, p 3, <http://www.soytransportation.org/issues/railcompetitionbbp092707.pdf>.

¹⁹ The Surface Transportation Board must approve rail segment construction under USC 10901. The company filing for approval must also meet EPA standards. By law, the STB must examine the historical and environmental effects of rail building or abandonment. The board encourages public discussion and the use of third parties to realize a workable solution.

²⁰ For a list of costs related to serving a railroad, see Office of Compliance, Office of Enforcement and Compliance Assurance, U.S. Environmental Protection Agency, “Profile of the Ground Transportation Industry Trucking, Railroad, and Pipeline,” September 1997, pp. 14-17, <http://www.epa.gov/Compliance/resources/publications/assistance/sectors/notebooks/grdtrnsnpt1.pdf>.

²¹ Eugene H. Blabey, II, “If It Ain’t Broke, Don’t Fix It,” *Railway Age*, October 2005.

²² Jerry A. Hausman, “Will New Regulation Derail the Railroads?” Competitive Enterprise Institute, October 1, 2001, <http://cei.org/pdf/2899.pdf>.

²³ “Railroad Competition and Service Improvement Act of 2007,” Consumers United for Rail Equity. http://www.railcure.org/pdf/HR-2125_Summary.pdf.

²⁴ William Tucker, “How Rent Control Drives Out Affordable Housing,” Policy Analysis, No. 274, Cato Institute, May 21, 1997, http://www.cato.org/pub_display.php?pub_id=1133&full=1.

²⁵ The Association of American Railroads claims that the majority of mergers were not among parallel lines but to lengthen lines under one company. “Rail Industry Structure and Market Behavior.”