Before the
SURFACE TRANSPORTATION BOARD
Washington, D.C. 20423

In the Matter of	)	**Docket No. EP 711**
	)	
Petition for Rulemaking to Adopt	)	
	)	
Revised Competitive Switching Rules	)	

COMMENTS OF THE COMPETITIVE ENTERPRISE INSTITUTE IN REPLY TO THE NATIONAL INDUSTRIAL TRANSPORTATION LEAGUE'S PETITION FOR RULEMAKING

August 2, 2011

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On behalf of the Competitive Enterprise Institute (CEI), a non-profit public policy organization that specializes in regulatory issues, I respectfully submit this letter in reply to the National Industrial Transportation League's ("League") *Petition for Rulemaking to Adopt Revised Competitive Switching Rules*.[1]

This comment letter develops the following points:

1. Forced switching agreements would endanger the future health of the railroad industry and the American economy as a whole.

2. The League and its members ignore the underlying economics of network industries and competition policy.

3. The Surface Transportation Board ("STB" or "Board") should again reject attempts by a minority of shippers to impose disastrous new regulations on the railroad industry.

1. Forced switching agreements would endanger the future health of the railroad industry and the American economy as a whole.

Shippers represented by the League have long engaged in anti-market behavior. Indeed, their complaints against the railroad industry have changed little during the past three decades following the enactment of the Staggers Act and will likely continue on a similar course indefinitely.

However, the railroad industry has changed a great deal. Post-Staggers reforms reversed the downward spiral of the industry, bringing private railroads back from near-death to their current comparatively healthy state. While the railroads' return on investment has increased steadily since the 1980s, from 4.4 percent to 8 percent in 2000-2009,[2] this period also coincided with huge gains for shippers and consumers. Since the Staggers Act was enacted, the United States has enjoyed a 55 percent decline in average inflation-adjusted rail rates (defined as revenue per ton-mile),[3] a 400 percent increase in railroad employee productivity (defined as ton-miles per employee),[4] and a 77 percent decline in train accident rates (defined as train accidents per million train-miles).[5]

The $480 billion the railroads have spent on their own networks since Staggers is almost entirely a function of the deregulated atmosphere. Forced or "open" access, in this case reciprocal switching, will result in less investment on the part of the railroads. Shareholders of the Class I railroads have been clear that if diminished profitability is imposed by regulatory fiat, they will attempt to mitigate their risks by demanding larger dividends and more share repurchases—meaning that a smaller percentage of diminished revenues will be reinvested into infrastructure.

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[1] The National Industrial Transportation League before the Surface Transportation Board in the matter of *Petition for Rulemaking to Adopt Revised Competitive Switching Rules*, July 7, 2011, Docket No. EP 711, Filing ID 230578.
[2] Association of American Railroads, "The Impact of the Staggers Rail Act of 1980," *Background Paper*, March 2011, p. 3, http://www.aar.org/KeyIssues/~/media/aar/Background-Papers/The-Impact-of-Staggers.ashx.
[3] Ibid., p. 2.
[4] Ibid., p. 4.
[5] Ibid., p. 3.

In the long-run, this would likely impact shippers and consumers in a variety of negative ways, which include: increased congestion, increased average rail rates, increased prices on retail goods and energy, decreased infrastructure quality, and increased train and employee accidents.

While it is true that so-called captive shippers indeed exist, the number of shippers lacking access to multiple rail carriers or viable alternative modes is not known.[6] Regardless, captive shippers are a small minority and their disproportionately vocal presence in the marketplace does not justify undertaking extremely risky reregulation of the railroad industry.

Essentially, this long-standing dispute comes down to one core question: Can railroads operate their track as owners? They are track-owners, certainly. But the historically revisionist shippers represented by the League appear to yearn for the 1970s—that lost decade of excessive regulation and resulting private rail industry ruin, and one in which government-owned Conrail assumed the unprofitable operations of bankrupt carriers in the Northeast and Midwest. This is an era that the United States cannot afford to repeat, particularly during the present economic period of low growth. If the League has its way, jobs will be lost, efficiency will decline, safety will suffer, and consumers will ultimately pay the price.

2. The League and its members ignore the underlying economics of network industries and competition policy.

Most of the League's arguments contained in its petition are of a legal basis, and almost all are completely devoid of sound economic reasoning or evidence. Under statute, it is quite clear that the Board "may" (not "shall") regulate carriers and force them "to enter into reciprocal shipping agreements, where it finds such agreements to be practicable and in the public interest, or where such agreements are necessary to provide competitive rail service."[7] This regulatory authority is not at issue, but an economic understanding of the peculiarities of network industries is required in order to make a determination whether or not forced access agreements would be "in the public interest" and whether or not the railroads are engaging in anticompetitive behavior.

Railroads, as virtually all infrastructure-intensive network industries, face large sunk costs that they must recoup by setting rates significantly above a 100 percent revenue to variable cost (R/VC) ratio. Industries with large sunk investments inherently face greater uncertainty, and they must price away this risk. This is particularly true for low-demand railroad segments, such as those on which most of the shippers represented by the League find themselves. Without factoring in the risk to these sunk investments, as the League fails to do, one cannot seriously discuss this market.

For example, if the economy double-dips into another recession or if demand for rail services decreases, the railroads' sunk investments cannot be simply sold or used elsewhere. They are permanent. However, while the cost-based regulation proposed by the League puts a ceiling on the possible (in a probability distribution) positive economic returns of regulation, there is no floor on possible deleterious economic effects. MIT economist Jerry Hausman notes in his study

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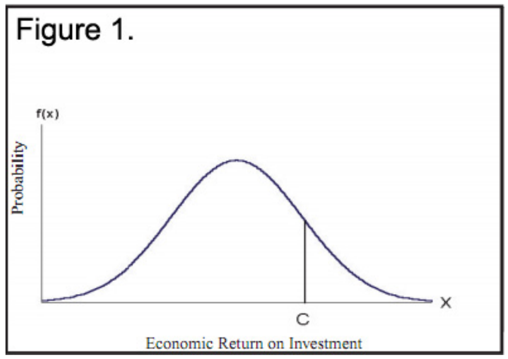
[6] Brian A. Weatherford, Henry H. Willis, and David S. Ortiz, *The State of U.S. Railroads: A Review of Capacity and Performance Data*, Santa Monica, Calif.: RAND Supply Chain Policy Center, 2008, p. 5 at fn. 5, http://www.rand.org/content/dam/rand/pubs/technical_reports/2008/RAND_TR603.pdf.

[7] 49 U.S.C. § 11102(c).

for CEI that this results in an asymmetric and truncated probability distribution of returns on sunk investments (Figure 1, where C represents the limit on potential positive economic returns).[8]



Moreover, nowhere in its outlined "four basic principles"[9] or in the conditions spelled out in Appendix A[10] or, for that matter, in any part of the League's petition is there any proposed trigger mechanism to prevent rates from falling dangerously low. The downward price pressure of mandated reciprocal switching would drive rates toward 100 percent of R/VC, which would mean a diminishing portion of the risk of sunk investment—particularly with respect to riskier low-demand segments—would be factored into rail rates. If this were to occur, railroads would face little incentive to build out facilities or adopt new technologies.

Dr. Hausman points out an additional flaw in the case for forced access:

> An additional problem arises because "open access" regulation decreases competitors' incentive to invest. 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.[11]

In essence, the League is calling for free-rider "competition." A clear example of the dangers of such regulation is found in the case of another regulated network industry. The telecommunications industry in the 1970s and 1980s was subject to open access regulations with lengthy depreciation schedules. The result was underinvestment and stagnation, with companies delaying the adoption of digital private branch exchanges (PBXs) and digital switches because of the excessive assumed depreciation life of the analogue switches.[12] Following passage of the Telecommunications Act of 1996, the Federal Communications Commission implemented a disastrous set of open access policies contained in its August 1996 Local Competition Order.[13] These well-intentioned policies crushed infrastructure-owning wireline incumbents to the

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[8] Jerry Hausman, "Will New Regulation Derail the Railroads?" Washington, D.C.: Competitive Enterprise Institute, October 1, 2001, p. 7, http://cei.org/pdf/2899.pdf. *See also*, Jerry Hausman and Stewart Myers, "Regulating the United States Railroads: The Effects of Sunk Costs and Asymmetric Risk," *Journal of Regulatory Economics* Vol. 22 No. 3, 2002, pp. 287-310.
[9] The National Industrial Transportation League before the Surface Transportation Board in the matter of *Petition for Rulemaking to Adopt Revised Competitive Switching Rules*, p. 7.
[10] Ibid., p. 65.
[11] Jerry Hausman, "Will New Regulation Derail the Railroads?" p. 8.
[12] Ibid., p. 7.
[13] Adam Thierer and Clyde Wayne Crews, Jr., *What's Yours is Mine: Open Access and the Rise of Infrastructure Socialism*, Washington, D.C.: Cato Institute, 2003, pp. 55-64.

temporary benefit of free-riding new market entrants who did little to build out facilities.[14] The wireless industry was not hampered with such regulations and thrived as a result.[15]

Ignoring these economic realities and affirming the rent-seeking request of the League would advance neither "the public interest" nor "competitive rail service" in any meaningful sense. On the contrary, the expected outcome would harm both the public's interest in efficient freight rail and true competition in the railroad industry.

3. The Surface Transportation Board should again reject attempts by a minority of shippers to impose disastrous new regulations on the railroad industry.

The shippers represented by the League are again seeking to revise history for their benefit. They mention the revised 2009 Laurits R. Christensen Associates report to the STB as purporting to support their claim that mandating reciprocal switching agreements would greatly help the shippers while minimizing losses to the railroads.[16] Of course, Dr. Hausman's analysis above throws cold water on this notion.

Even assuming these arrangements would result in net benefits, a conclusion that is extremely dubious given the theory and history of open access and network industries, the League cannot show that the railroad industry has engaged in the necessary *Midtec* conditions to justify remedying alleged anticompetitive behavior. These include, as the League itself admits,[17] "classical categories of competitive abuse: foreclosure; refusal to deal; price squeeze; or any other recognizable forms of monopolization or predation."[18]

In Christensen Associates's final January 2010 report to the Board, they conclude that "increases in the railroads' generic costs […] were driven primarily by the spike in fuel prices in recent years. Thus, while shippers have been exposed to increasing RPTMs after 2004, it appears that costs rather than markup factors are largely the culprits."[19] It is worth noting that average rail rates have declined from their peak in 2008.[20] If the increasing exercise of market power ("markup factors") was not the driver of rail rate increases between 2004-2008, the League's case for forced access given the *Midtec* conditions falls flat.

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[14] Ibid.
[15] Jerry Hausman, "Will New Regulation Derail the Railroads?" p. 8.
[16] The National Industrial Transportation League before the Surface Transportation Board in the matter of *Petition for Rulemaking to Adopt Revised Competitive Switching Rules*, p. 29.
[17] Ibid., p. 14.
[18] *Midtec Paper Corporation, et al.* v. *Chicago and North Western Transportation Company (Use of Terminal Facilities and Reciprocal Switching Agreements)*, 3 I.C.C. 2d 171 (1986), No. 39021, 1986 ICC LEXIS 42, at *5.
[19] Surface Transportation Board, "An Update to the Study of Competition in the U.S. Freight Railroad Industry," Final Report, prepared by Laurits R. Christensen Associates, January 2010, p. 6-17, http://www.stb.dot.gov/stb/docs/CompetitionStudy/Final/January%202010%20Report.pdf.
[20] Association of American Railroads, "The Impact of the Staggers Rail Act of 1980," p. 4.

Conclusion

As we stated in our multiple filings to the Board in the Ex Parte No. 705 proceeding, the STB should resist renewed attempts to reregulate the railroad industry.[21] As the League fails to appreciate the dangers of forced reciprocal switching agreements, ignores the underlying economics and the peculiarities of network industries, and fails to show the "anticompetitive" *Midtec* conditions were met, the Board should not issue a notice of proposed rulemaking in response to the League's *Petition for Rulemaking to Adopt Revised Competitive Switching Rules*.

[21] *See*, Comments of the Competitive Enterprise Institute before the Surface Transportation Board in the matter of *Competition in the Railroad Industry*, April 12, 2011, Docket No. EP 705, Filing ID 229233; *and* Comments of the Competitive Enterprise Institute in Reply to Initial Comments of Consumers United for Rail Equity (CURE) before the Surface Transportation Board in the matter of *Competition in the Railroad Industry*, May 27, 2011, Docket No. EP 705, Filing ID 229648.