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

In the Matter of	**)**	**Docket No. EP 705**
	)	
Competition in the	**)**	**FR Doc. No. 2011-774**
	)	
Railroad Industry	**)**	

COMMENTS OF THE COMPETITIVE ENTERPRISE INSTITUTE

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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 to supplement our March 21 comments in reply to the Surface Transportation Board's (hereafter STB or Board) request for comments on *Competition in the Railroad Industry*.[1]

This comment letter develops the following points:

1. "Bottleneck" pricing faced by "captive" shippers reflects low-demand and risks to capital investment.
2. Increasing regulation on "bottleneck" carriers would enhance neither competition nor economic efficiency.
3. "Open access" regulation would increase the risk of investment, particularly to underserved areas.
4. Regulatory inefficiencies in the railroad industry do exist. However, this is a matter more appropriately addressed by Congress, not through STB rulemaking.

1. Low demand along "bottleneck" routes and the related heightened risk to capital investment are reflected in rates faced by "captive" shippers.

In recent years, some Members of Congress have proposed legislation to cap the freight rates that railroads can charge so-called "captive shippers." Such reregulation would roll back 30 years of market liberalization and nearly a century of bottleneck regulation and judicial precedent. It would partially erase the positive gains enjoyed by the railroad industry, shippers, and consumers.

Captive shippers, those who lack economical transport alternatives to a single rail line, are already subject to some regulatory protection. From an economic efficiency standpoint, these shippers should be expected to contribute the most to the railroads' fixed costs.[2] Railroads are extremely capital intensive—ongoing maintenance and expansion are both necessary for profitability—and should not be faulted for capturing revenue in the most efficient, socially beneficial manner possible given competitive constraints.[3]

Some shippers currently subject to rates they deem unfair have called for establishing price controls based upon variable costs (setting a maximum revenue-to-variable-cost ratio, R/VC) that would effectively eliminate rates based upon Ramsey principles (inverse elasticity of demand pricing). But these commercial interests know full well that judging rate adequacy on variable costs alone ignores the large fixed costs faced by railroads currently operating bottleneck lines.[4]

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[1] Surface Transportation Board, *Competition in the Railroad Industry*, January 14, 2011, Docket No. EP 705, FR Doc No. 2011-774.

[2] Pricing based upon Ramsey principles is the most efficient way for a firm that faces decreasing marginal and average costs to recoup costs from its customers—to maximize societal welfare.

[3] *See*, *e.g.*, Russell Pittman, "The Economics of Railroad 'Captive Shipper' Legislation," *Economic Analysis Group Discussion Paper*, U.S. Department of Justice, Antitrust Division, Economic Analysis Group, January 2010, p. 16, http://www.justice.gov/atr/public/eag/255003.pdf.

[4] Jen Smith-Bozek, "The Railroad Competition and Service Improvement Act: Why Government-Enforced 'Competition' Will Not Work," *CEI OnPoint* No. 147, Washington, D.C.: Competitive Enterprise Institute, December 11, 2008, p. 4, http://cei.org/sites/default/files/Jen%20Smith-Bozek%20-%20The%20Railroad%20Competition%20and%20Service%20Improvement%20Act-1.pdf.

The risk to financing investment along these low-demand segments is also significantly greater than higher-traffic routes, as the ability to recoup capital costs for a given segment can be determined by the market entry or exit of very few shippers. Enacting rigid price controls, whether via legislation or unilateral rulemaking by STB, would deter future investment on the part of railroads. Given that congestion is already a serious concern for major Class I hubs such as Chicago, further undermining the incentive to invest in infrastructure is a particularly dangerous regulatory game.

2. Enhancing the regulation of "bottleneck" rail carriers would harm the rail industry, shippers, and consumers.

Shippers subject to bottleneck rates understandably would like to pay less. However, while restricting shipping rates—particularly when the regulation relies on a cost-based rate—might temporarily be a boon to shippers, the long-term impact of further restricting market-based rate-setting would harm railroads, shippers, and consumers.

Demand for Class I freight service is expected to increase substantially during the coming decades.[5] Limiting the ability of railroads to recoup capital costs in the most efficient manner possible given competitive constraints would lead to decreased investment in new technologies and additional capacity that will be required to keep rates down in the long-run.

Some have speculated that recent increases (since 2004) in shipping rates are the result of suboptimal monopolistic behavior on the part of railroads. A study commissioned by the Board found that recent increases in revenue per ton-mile (RPTM) were not the result of an alleged "increased exercise of market power by the railroads."[6] Furthermore, a former STB chairman has estimated that only 15 to 20 percent of freight rail movement would be considered "captive" by the Board.[7] The STB should not risk harming the majority of shippers in order to satisfy the demands of a minority who lack economical transport alternatives to their present single rail carrier.

If demand along current bottleneck segments were to increase, it is more likely that additional railroads would invest in infrastructure and enter the market. But captive shippers are essentially demanding that railroad competition be somehow enhanced using blunt and anti-competitive regulatory tools such as rigid price controls. It is hard to believe that competing railroads would have a greater incentive to woo a small number of customers over even slimmer pickings due to imposed cost-based rate-setting.

[5] Association of American Railroads, "National Rail Infrastructure Capacity and Investment Study," prepared by Cambridge Systematics, Inc., September 2007, Figure 5.4, p. 5-5, http://www.camsys.com/pubs/AAR_Nat_%20Rail_Cap_Study.pdf.

[6] 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. 5-20, http://www.stb.dot.gov/stb/docs/CompetitionStudy/Final/January%202010%20Report.pdf.

[7] John Frittelli, "Railroad Access and Competition Issues," *CRS Report for Congress*, Congressional Research Service, August 3, 2007, p. 1, available for download at: http://www.publicpower.org/files/PDFs/CRSReportoRailCompetitio80307.pdf.

Since the Staggers Act was enacted in 1980, the railroad industry has invested approximately $480 billion to modernize its infrastructure and operations.[8] Only recently, following decades of increasing productivity, has the industry been able to collect revenue sufficient to ensure long-term network viability.[9] Uncertainty about or an inability to recoup capital costs would make investors leary of financing similar upgrades in the future. Thus, adding additional regulatory burdens to the industry would only serve to reduce societal welfare for the limited benefit of a minority of shippers. The STB should seek to preserve regulatory certainty, rather than undermine a crucial sector of the American economy.

3. Mandating "open access" would undermine railroads' incentive to invest in underserved areas.

As a network industry, railroads cannot simply unbundle services in a costless manner. Freight contracts are structured in order to maximize revenues at a point where it is profitable to continue operating low-demand lines or to invest in new infrastructure. But a minority of shippers who lack economical transport alternatives to their present rail line have advocated that regulators force "open access," or "reciprocal switching," rules on the railroad industry.

Expanding industry regulation to cover open access would reduce access to rail in the future, as railroads face diminished incentives to invest in infrastructure that serve only a small handful of shippers. These shippers would face rates closer to variable costs, but these rates would neither reflect the large capital costs nor the inherently higher risks due to the presence of sizable sunk investments, as has been repeatedly noted by Massachusetts Institute of Technology economist Jerry Hausman.[10] This would be compounded by extended regulatory depreciation periods, as the regulatory history with other forced "open access" requirements for network industries demonstrates.

For example, 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.[11] 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.[12] These well-intentioned policies crushed infrastructure-owning

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[8] 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.
[9] Association of American Railroads, "The Staggers Act: Balanced Regulation That Works," *Background Paper*, August 2010, p. 2, http://www.aar.org/~/media/aar/backgroundpapers/the-staggers-act-balanced-regulation-that-works.ashx.
[10] *See, e.g.*, 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.
[11] 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.
[12] 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.

wireline incumbents to the temporary benefit of free-riding new market entrants who did little to build out facilities.[13]

Following industry deregulation, railroads that found switching each other's traffic to be more efficient generally consolidated operations and infrastructure by merging into a single company, rather than continue with switching contracts and other cost-sharing arrangements as separate companies.[14]

4. Economic inefficiency arising from the present regulatory apparatus could be reduced within the railroad industry, but this requires action by Congress, not the Board.

Captive shippers have often complained that they and their customers pay disproportionately for the inefficiencies of the railroad industry. This is true to some extent. The freight rail industry suffers from inefficient practices, but these are not the result of a lack of adequate regulation or of the deregulation of recent decades. On the contrary, outdated and onerous labor regulations—stemming primarily from the Railway Labor Act (RLA)—and the workplace rules that result from railroad industry collective bargaining agreements contribute significantly to these problems and should be revisited.

However, the action required is beyond the scope of the STB and would require legislative reform of the RLA. For example, the process to decertify a union under the RLA is incredibly difficult. Industries other than the railroads and airlines are regulated under the National Labor Relations Act and have a far more straightforward procedure to decertify unions, which "allows employees to hold an election to decertify a union if 30 percent of workers in a bargaining unit show interest."[15] In contrast:

> It is technically possible for workers unionized under the Railway Labor Act to decertify a union, but it is extremely difficult. The workers have to wait two years after the union is certified to launch what is called a "straw man" election. Worse, an option for outright decertification may not be placed on the ballot. Instead, following the two-year wait, the workers seeking decertification then have to put up an individual or create a fictitious organization—the straw man—to challenge the incumbent union.[16]

Removing barriers to decertification could significantly challenge the union-dominated status quo, which is responsible for unnecessary, expensive workplace rules advocated by the various trade unions that represent different classes of railroad workers.

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[13] Ibid.
[14] Smith-Bozek, p. 5.
[15] Russ Brown and Ivan Osorio, "The Case for Reform of the Railway Labor Act," *OnPoint* No. 172, Washington, D.C.: Competitive Enterprise Institute, February 24, 2011, p. 2, http://cei.org/sites/default/files/Russ%20Brown%20and%20Ivan%20Osorio%20-%20The%20Case%20for%20Reform%20of%20the%20RLA.pdf.
[16] Ibid.

Conclusion

The Surface Transportation Board should resist attempts to reregulate the railroad industry, which, according to the Bureau of Transportation Statistics' *2007 Commodity Flow Survey*, accounts for about 46 percent of total ton-miles moved annually.[17] While there are indeed regulatory inefficiency problems in the railroad industry, reform must come from Congress, not the STB. Given the very real dangers of reregulation, we respectfully request the Board to oppose regulatory changes related to *Competition in the Railroad Industry* at this time.

[17] Bureau of Transportation Statistics, *2007 Commodity Flow Survey*, April 2010, p. 4., http://www.bts.gov/publications/commodity_flow_survey/final_tables_december_2009/pdf/entire.pdf.