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Bait and Reciprocal Switch

Forced Access Regulation Threatens the Rail Renaissance

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America's freight railroad industry is one of the greatest success stories of economic liberalization. After decades of stifling regulation that nearly brought the railroads to ruin, Congress partially deregulated the industry. The results have been remarkable. Freight rates have fallen, industry productivity has skyrocketed, and the industry is now able to invest more than $20 billion back into its networks every year.[1]

The benefits of deregulation to shippers, consumers, and rail carriers are clear, but a number of commercial interests now support reregulating aspects of the industry. This pro-regulation coalition includes representatives from America's largest agriculture, coal, and petrochemical corporations. Some Members of Congress have supported legislation that threatens to reverse many of the industry's gains and would destabilize the current balance between public interest and healthy networks—so far with no success, but they are likely to keep trying.

A more significant threat comes from within the railroad industry's economic regulator, the Surface Transportation Board (STB). In the name of competition, a shipper lobby has proposed new access rules aimed at forcing railroads to interchange one another's traffic. The shippers claim the changes would not harm the affected railroads, citing limited and incomplete evidence from abroad. A better examination of the evidence refutes this claim and indicates that the proposed regulations would likely greatly reduce railroad investment and long-run efficiency.

Rather than imposing new regulatory burdens on the railroad industry in a clumsy attempt to improve outcomes for shippers, regulators and legislators should examine existing regulatory burdens that raise prices for customers and work to repeal them.

Background. After nearly collapsing and facing the prospect of nationalization in the 1970s, the U.S. railroad industry was partially deregulated by Congress at the end of that decade. The most significant piece of deregulatory legislation was the Staggers Rail Act of 1980, which ended many inefficient business practices that had been mandated by the Interstate Commerce Commission (ICC).[2] The reforms required by

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the Staggers Act were gradually implemented throughout the 1980s. Then in 1995, Congress passed the Interstate Commerce Commission Termination Act, which abolished the ICC, placing its diminished functions in the hands of the newly created Surface Transportation Board (STB). Today, the STB remains the economic regulator of the railroad industry.

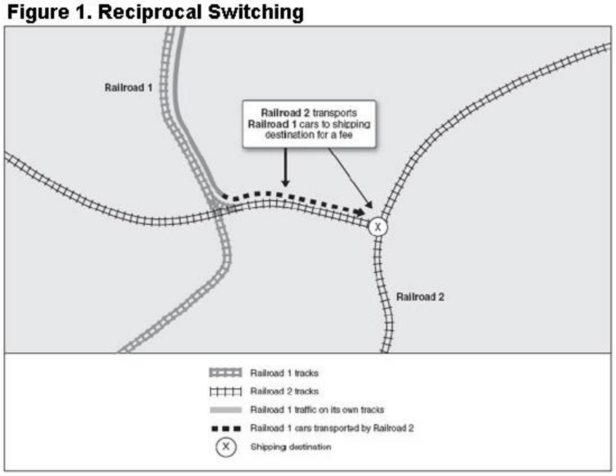
Since the Staggers Act, the health of the freight rail industry has improved dramatically. This has allowed railroads to invest over $500 billion of their own funds back into their networks.[3] But this recent success has benefited not only the railroads. Since 1980, inflation-adjusted freight rates have fallen by 44 percent, train accident rates have decreased by 80 percent, and rail employee productivity has increased by more than 400 percent.[4]

While often forgotten in transportation policy discussions, America's private freight rail network provides critical logistical support to the economy. It is estimated that if freight rail traffic were shifted to truck between 2000 and 2020, shippers would face an additional $1.4 trillion in costs—plus a conservative estimate of $64 billion in additional highway improvement costs due to the wear and tear from increased truck traffic.[5]

In the decades following partial deregulation, some shippers have called on policy makers to reregulate the railroads. Their proposals have included ending the railroad industry's limited antitrust law exemptions and forced access by way of mandatory "reciprocal switching." Thus far, all attempts to reregulate the railroad industry have failed, but reregulation advocates are not giving up.

Reciprocal Switching and Current Regulatory Action. The STB is currently considering a proposal from a shipper lobby that would, under certain conditions, impose reciprocal switching mandates on rail carriers in terminal areas. The current rulemaking—the most significant competition policy proceeding in 15 years[6]—threatens to reverse many of the gains that have resulted from partial deregulation.

Figure 1. Reciprocal Switching



Source: Government Accountability Office

Reciprocal switching refers to the practice of railroads interchanging each other's freight. For a fee, one railroad can contract with another to allow a customer served only by the latter rail carrier to access the former's network (see Figure 1). Some switching currently takes place, but it is voluntary. Disgruntled shippers wish to force railroads into terminal switching arrangements, claiming the railroad industry is anticompetitive and engaged in price gouging.

The current proceeding before the STB was prompted by the National Industrial Transportation League (NITL), a lobbying group supported by major shipping interests.[7] In January 2011, the STB opened a proceeding looking "to explore the current state of competition in the railroad industry and possible policy alternatives to facilitate more competition, where appropriate."[8] During this proceeding, NITL petitioned the STB to revise reciprocal switching rules.[9] The STB issued a decision in July 2012 to open a proceeding on NITL's petition.[10]

In its petition, NITL requested the STB to initiate a rulemaking to replace the current regulations governing access with a new dedicated part of the Code of Federal Regulations to lay out the conditions for mandatory terminal switching.[11] At its core, NITL's proposal seeks to force switching arrangements on rail carriers by removing the present requirement that abuse of market power must be found to mandate such practices. The proposal would automatically impose forced access if the following four conditions are met:

1. The shipper or shippers are served only by a single Class I railroad;
2. There is no effective intermodal or intramodal competition for the freight movements in question;
3. "A working interchange" exists or could exist within a "reasonable distance" of the shipper's or shippers' facilities; and
4. Mandating switching is feasible and safe, and would not unduly hamper the affected carrier's ability to serve its shippers.[12]

The first condition tells us little about market conditions. The third defines "reasonable distance" as "a radius of 30 miles of an interchange between the Landlord Class I Carrier and another carrier."[13] The fourth—in addition to the vagaries of "feasible" and "unduly"—depends on a determination of lack of effective competition under the second condition.

The above second condition is where the NITL proposal would make most of its mischief. NITL is arguing that the STB should not take into account potentially relevant information regarding product or geographic competition, even though such information can impact a carrier's investment, risk assessment, and service charges in various ways throughout the network. Instead, NITL's proposal would impose a "conclusive presumption" of lack of "effective competition" in segments where either of the following conditions is met:

1. **Rates reach or exceed a revenue-to-variable-cost ratio (R/VC) of 240 percent.**[14] Current law permits the STB to intervene when R/VC exceeds 180 percent in order to serve a public interest. However, R/VC ratios between 180 and 300 percent are common—affecting approximately one-seventh of traffic on a ton-miles basis—but that share has been declining over time.[15] The 240 percent of R/VC standard is within that customary range, but is nevertheless arbitrary, as it ignores the wide variation in risk to sunk investments across

network segments, and would rely on the outdated Uniform Railroad Costing System to make determinations under it.[16]
2. **Any carrier has a market share of 75 percent or more.** This standard is even more absurd. The risk of these low-demand segments is quite large and it would only take the exit of one or a couple of shippers from the market to render the segment unprofitable. This would discourage future railroad investment aimed at increasing capacity and access for shippers with similar characteristics. It would ultimately harm rail carriers, shippers, and consumers by reducing network efficiency and access.[17]

Instead of having the STB rely on actual evidence of abuse, NITL proposes that regulators make arbitrary and capricious determinations based on faulty data in order to allow its members to extract short-term rents from rail carriers. The current regulations, while far from perfect, are superior to the blatant rent-seeking in NITL's proposal.

Reregulation Proposal Ignores Key Facts and Threatens Investment. Giving in to the political demands of vocal captive shippers would provide limited rate relief to said shippers in the short run, but the real danger lies with reregulation's impact on railroad investment. A reduction in railroad investment now will harm railroads, shippers, consumers, and the overall economy in the long run.

NITL, in its March 2013 comment filing to the STB, argues that its forced access requirements proposal will not impact railroad efficiency because similar regulations in Canada have not had obvious deleterious effects.

Contrary to NITL's claim that "[t]here is no reason to believe that the same dynamic would not take place in the United States" under its competitive switching proposal,[18] adopting Canadian-style forced access rules would increase railroad network complexity and reduce efficiency. To claim that the United States and Canada are materially similar with respect to railroad service and access is inappropriate for three reasons:

1. The U.S. has nearly 10 times the population density of Canada;
2. The U.S. has four times as much track per square mile as Canada; and
3. There are on average 10 times as many interchanges per major metropolitan area in the U.S. than in Canada.[19]

For these reasons, it makes no sense to argue that the adoption of Canadian-style interswitching rules would materially impact U.S. rail carriers in a manner similar to the impact on Canadian carriers.

This potential for high error costs and regulatory uncertainty is not merely academic. At a June 2011 STB hearing during the Ex Parte 705 proceeding, Thomas Wadewitz, managing director of Airfreight and Surface Transportation at J.P. Morgan Securities, highlighted the dangers of reregulation from the perspective of investors. Wadewitz noted:

> Uncertainty is a source of risk. So while the outcome [of regulatory change] may be favorable, if an extended process of considering change in regulation is pursued, that can act as a headwind to rail investors and also to investment decisions.[20]

In response to questioning from STB Commissioner Francis Mulvey, Wadewitz said that imposing regulations that restrict market pricing will reduce earnings, thereby reducing the investor attractiveness of railroad securities and shareholder willingness to tolerate significant reinvestment of profits—in the end reducing much-needed investment in railroad infrastructure:

> But if ultimately you put in place those changes that do negatively affect pricing, which then affects earnings growth and returns, then there will be less interest from shareholders, and it will incentivize the managements to take a different course … So in industries where returns are not particularly good, then shareholders will put more pressure on the industry to invest less. So if your desired result is less investment, then that can be a course that you go to.[21]

From a practical perspective, NITL's competitive switching proposal is simply irresponsible. It would deter railroad investment when capacity constraints are becoming more serious. Ironically, level of service now—and in the future—is one of the biggest shipper concerns. Rail traffic is expected to significantly increase in the coming decades, driven by the continuing rise of intermodal movements and new sources of North American petroleum. While the railroads are spending tens of billions of dollars of their own funds annually in order to meet this demand, much more is needed.

An oft-repeated justification for reregulatory intervention in the name of competition is a widely held but false assumption that railroad deregulation has been completed. Brookings Institution economist Clifford Winston disputes this claim and recommends that policy makers should reject new forced access regulations:

> In fact, railroads still have a way to go to optimize service times and reliability, to be fully responsive to shippers, and to achieve potential logistical and operational efficiencies. A fully deregulated environment will spur the additional adjustments that the industry must make to accomplish these goals.[22]

The ICC and STB's general regulatory philosophy following the Staggers Act was accurately described by economists Douglas W. Caves, Laurits R. Christensen, and Joseph A. Swanson as "conservative in [its] exercise of authority."[23] The STB must be cognizant of the fact that if it oversteps its boundaries by adopting NITL's proposal, it likely will face enhanced and deserved congressional scrutiny.

Where's the Anticompetitive Beef? As Winston has noted, rail carriers have faced intense competition—both intramodal and intermodal—since deregulation. Captive shippers exist, but the problem is far smaller than the shipper lobby claims. Furthermore, the STB's rate complaint process is far too cumbersome and costly.[24] Winston argues:

> [G]overnment should not pursue policies such as mandatory access to increase competition. Instead, it would be preferable to eliminate the Surface Transportation Board and completely deregulate rail rates while instituting market-based mechanisms to address the captive shipper issue. In the process, the potential for policymakers to adopt measures that effectively re-regulate the industry would be foreclosed.[25]

Congress should take this matter seriously. The STB is approaching functional obsolescence and will definitively reach that milestone if it caves to NITL's rent-seeking demands. Grimm and Winston recommended continuing the rate deregulatory process, eventually leading to the abolition of the STB.[26] This goal could be achieved by a compromise between shippers and railroads.[27] As Winston later writes:

> By negotiating an end to residual rate regulation, the rail industry could substantially lessen the possibility that the board or Congress could introduce new regulations that undermine industry performance. […] Elimination of the board would allow railroads to reduce administrative and lobbying costs and perhaps raise rates in some markets. In return, the industry could offer shippers some recourse for reducing rates, such as identifying specific situations in a market when an alternative rail carrier would be given access to an incumbent rail carrier's track.[28]

A number of shippers, including NITL, have attacked what they decry as railroads' excessive profits. This claim is unsupported by the most comprehensive and robust economic analyses. While the railroad industry is now enjoying a level of profitability that would have been unheard of in the decades prior to partial deregulation,[29] this is a very new development. Until recently, America's Class I railroads were not even revenue-adequate.[30] Furthermore, railroads are one of the most capital intensive industries in existence, which necessarily entails higher financial risk.[31] This additional risk leads investors to demand higher profit levels.

In one such study, economists Siew Hoon Lim and C.A. Knox Lovell developed a model to determine the causal factors behind profit and productivity changes over time. As they note:

> Linking economic performance to financial performance is important, especially in a quasi-regulatory environment in which the regulator wants to encourage better economic performance in order to protect consumers of railroad services without bankrupting the railroads. *The regulator absolutely must take into account the financial implications (for the firms as well as for the*

> *consumers) of regulatory decisions, and the linking between economic and financial performance should not be overlooked*.[32] [Emphasis added]

This point—which was also underscored by Wadewitz in recent testimony before the STB—is too often ignored by shipping interests. Consumer welfare is not advanced if supposedly pro-consumer regulations greatly diminish the health of railroads and result in quality of service reductions across the network.

Contrary to some shippers' arguments that railroads have been systematically exercising market power to consumers' detriment, Lim and Lovell found that the divergence between productivity and profitability in the railroad industry during 1996-2003 can be attributed largely to increasing input prices and capacity constraints. More recent analysis largely confirms Lim and Lovell's conclusion. For instance, in Christensen Associates' final January 2010 report to the STB, 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 [revenue per ton-miles] after 2004, it appears that costs rather than markup factors are largely the culprits."[33]

Thus far, no credible evidence has been put forth that railroads are behaving in an anticompetitive manner that would justify reregulation or other political interventions. Unfortunately, this has not stopped NITL from advocating forced access policies based on the baseless assumption of market power abuse on the part of the railroads. While the disgruntled shippers can be vocal, the prudent course of action for regulators is to reject these complaints.

Conclusion. The U.S. railroad industry languished for decades under a regulatory regime that nearly drove it to extinction. Thankfully, policy makers in the 1960s and 1970s realized that deregulatory measures were needed to save the industry from collapse and nationalization. However, there is some indication now that our contemporary policy makers have forgotten the lessons from the past. Repeating the mistakes of regulation would be a dangerous mistake that would compound our present sluggish economic growth and uncertainty.

The STB, while traditionally conservative in its exercise of authority, is facing intense pressure from some shipping interests to adopt regulations that would reduce railroads' investment, flexibility, and quality of service across their networks. Such action would not only harm the railroads, but ultimately the shippers who use their networks and the consumers who benefit from efficient goods movements.

NITL's competitive switching proposal, and any similar proposals, should be rejected. A more efficient way to improve the welfare of the disgruntled shippers would be to encourage carriers and shippers to improve the costly rate dispute resolution process. But such arrangements are unlikely to be realized until Congress commits to completing the deregulatory process by seriously contemplating the abolition of the STB.

Notes

[1] "Overview of America's Freight Railroads," Association of American Railroads, April 2013, p. 4, https://www.aar.org/keyissues/Documents/Background-Papers/Overview-US-Freight-RRs.pdf.

[2] See, e.g., Marc Scribner, "Slow Train Coming? Misguided Economic Regulation of U.S. Railroads, Then and Now," *Issue Analysis* 2013 No. 1, Washington, D.C.: Competitive Enterprise Institute, March 2013, http://cei.org/issue-analysis/slow-train-coming.

[3] "The Impact of the Staggers Rail Act of 1980," Association of American Railroads, April 2013, p. 1, https://www.aar.org/keyissues/Documents/Background-Papers/Impact%20of%20the%20Staggers%20Act%20April%202013.pdf.

[4] Ibid.

[5] "Freight-Rail Bottom Line Report," American Association of State Highway and Transportation Officials, 2003, p. 1, http://www.camsys.com/pubs/FreightRailReport.pdf.

[6] Decision of the Surface Transportation Board in the matter of *Review of Rail Access and Competition Issues*, "Request for Comments," February 20, 1998, Docket No. EP 575, 63 FR 9296.

[7] Current members listed on NITL's website include Cargill, Chevron, Citgo, Emerson Electric, ExxonMobil, Kohl's Department Stores, Land O'Lakes, U.S. Steel, and United Sugars, http://www.nitl.org/memassa.htm.

[8] Notice of the Surface Transportation Board in the matter of *Competition in the Railroad Industry*, January 11, 2011, Docket No. EP 705, 76 FR 2748.

[9] Petition for rulemaking of the National Industrial Transportation League before the Surface Transportation Board, July 7, 2011, Docket No. EP 711, Filing ID 230578.

[10] Decision of the Surface Transportation Board in the matter of *Petition for Rulemaking to Adopt Revised Competitive Switching Rules*, July 25, 2012, Docket No. EP 711, 77 FR 45327.

[11] 49 CFR 1144.2. The new part would be at 49 CFR 1145.

[12] Petition for rulemaking of the National Industrial Transportation League before the Surface Transportation Board, July 7, 2011, Docket No. EP 711, Filing ID 230578, Appendix A, p. 65.

[13] Ibid.

[14] A study recently commissioned by the STB strongly cautioned against using revenue-to-variable-cost ratios (R/VC) as the sole quantitative market dominance test: "While R/VC may, applied carefully, be able to identify categories of shipments that travel at high rates relative to costs, the R/VC ratio is not very useful as an indicator of the presence of market structure factors that would increase shippers' 'captivity' to railroads. The weak relationships between R/VC ratios and market structure factors imply that correctly assessing the presence of market-dominant behavior requires direct assessment of relevant market structure factors. *Thus, regulatory reforms that would establish R/VC tests as the sole quantitative indicator of a railroad's market dominance are inappropriate.*" [Emphasis added] Surface Transportation Board, "A Study of Competition in the U.S. Freight Railroad Industry and Analysis of Proposals that Might Enhance Competition," prepared by Laurits R. Christensen Associates, November 2009, p. 11-29, http://www.stb.dot.gov/stb/docs/CompetitionStudy/Volume%202.pdf.

[15] 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. 5-19, http://www.stb.dot.gov/stb/docs/CompetitionStudy/Final/January%202010%20Report.pdf.

[16] *See, e.g.,* Douglas W. Caves, Laurits R. Christensen, and Joseph A. Swanson, "The Staggers Act, 30 Years Later," *Regulation*, Winter 2010-2011, p. 30: "Bluntly, the [Uniform Rail Costing System] is based on out-of-date statistical analyses, has other ad hoc assignments of costs, and is an inappropriate method for estimating the costs of specific movements."

[17] Petition for rulemaking of the National Industrial Transportation League before the Surface Transportation Board, July 7, 2011, Docket No. EP 711, Filing ID 230578, Appendix A, p. 65. NITL's proposal summarized its second condition for forcing switching as follows: "The petitioner shows that there is no effective inter- or intramodal competition for the movements for which

competitive switching is sought. There would be no consideration of product or geographic competition. There would be a conclusive presumption that there is no such effective competition where either: (a) a movement for which competitive switching is sought has an R/VC ratio of 240% or more; or (b) the Landlord Class I carrier has handled 75% or more of the freight volume transported for a movement for which competitive switching is sought in the twelve months prior to the petition seeking switching."

[18] Comments of the National Industrial Transportation League before the Surface Transportation Board in the matter of *Petition for Rulemaking to Adopt Revised Competitive Switching Rules*, March 1, 2013, Docket No. EP 711, Filing ID 233892, p. 60.

[19] *The World Factbook* 2013-14, Washington, D.C.: Central Intelligence Agency, 2013, https://www.cia.gov/library/publications/the-world-factbook/index.html; *and* William J. Rennicke, "Potential Implications of EP711 on the Health of the US Freight Rail Industry," Oliver Wyman Group, November 2012, p. 10, http://rail.railplanning.com/files/2012/10/Rennicke_20121010-Rail-Switching-Atlanta-final.pdf. *See also* Verified Statement of William J. Rennicke before the Surface Transportation Board in the matter of *Petition for Rulemaking to Adopt Revised Competitive Switching Rules*, March 1, 2013, Docket No. EP 711, Filing ID 233881.

[20] Transcript of a public hearing before the Surface Transportation Board in the matter of *Competition in the Railroad Industry*, Docket No. 705, June 22, 2011, p. 482, http://stb.dot.gov/TransAndStatements.nsf/8740c718e33d774e85256dd500572ae5/e163ad72a36c38028525793c000ce7e8/$FILE/0622STB.pdf.

[21] Ibid., p. 497.

[22] Clifford Winston, "The United States: Private and Deregulated," *Competition in the Railway Industry: An International Comparative Analysis*, Eds. José A. Gómez-Ibáñez and Ginés de Rus, Northampton, Mass.: Edward Elgar Publishing, 2006, p. 150.

[23] Caves et al., p. 30.

[24] Curtis Grimm and Clifford Winston, "Competition in the Deregulated Railroad Industry: Sources, Effects, and Policy Issues," *Deregulation of Network Industries: What's Next?*, Eds. Sam Peltzman and Winston, Washington, D.C.: Brookings Institution Press, 2000.

[25] Winston, "The United States: Private and Deregulated," pp. 149-150.

[26] Grimm and Winston.

[27] A shipper-carrier alliance to abolish the Surface Transportation Board may not be as strange as it first sounds. Former National Industrial Transportation League President Edward Emmett told a reporter in 2000 after several years of unsuccessfully lobbying the STB for regulatory changes, "The fundamental question is why have an STB? Maybe we don't need it." Frank N. Wilner, "Fighting Words," *Traffic World*, October 2, 2000, p. 16.

[28] Winston, *Last Exit: Privatization and Deregulation of the U.S. Transportation System*, Washington, D.C.: Brookings Institution Press, 2010, p. 30.

[29] Current profitability comparisons by sector are available at "Net Profit Margin, Industry Summary," Yahoo! Finance, http://biz.yahoo.com/p/sum_qpmd.html. On October 4, 2013, the railroad industry's net profit margin was listed as 16.1 percent.

[30] "Freight-Rail Bottom Line Report," p. 40.

[31] "Freight Railroad Capacity and Investment," Association of American Railroads, April 2013, p. 2, https://www.aar.org/keyissues/Documents/Background-Papers/Freight%20Railroad%20Capacity%20and%20Investment.pdf.

[32] Siew Hoon Lim and C.A. Knox Lovell, "Profit and Productivity of US Class I Railroads," *Managerial and Decision Economics* Vol. 30, January 2009, p. 436.

[33] Surface Transportation Board, "An Update to the Study of Competition in the U.S. Freight Railroad Industry," p. 6-17.