VOLUME 3

POLICY ANALYSIS AND FUTURE DIRECTIONS FOR RESEARCH

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Volume 3: Contents

ABBREVIATIONS
LIST OF FIGURES

CHAPTER 19 INTRODUCTION AND OVERVIEW OF VOLUME 3

19A. HISTORY OF U.S. RAILROAD LEGISLATION AND REGULATION 19-1
19B. DESCRIPTION OF RECENT RAILROAD INDUSTRY POLICY PROPOSALS.... 19-2
19C. ECONOMIC ANALYSIS OF RECENT POLICY PROPOSALS 19-2
19D. CONCLUSIONS AND DIRECTIONS FOR FUTURE RESEARCH 19-3

CHAPTER 20 HISTORICAL AND CURRENT RAILROAD LEGISLATION AND REGULATION

INTRODUCTION 20-1
20A. LEGISLATIVE AND REGULATORY HISTORY OF THE RAILROAD INDUSTRY 20-2
Early State Regulation 20-2
Interstate Commerce Act – 1887 20-2
The “3-R” Act – 1973 20-3
The “4-R” Act – 1976 20-3
The Staggers Rail Act – 1980 20-4
The ICCTA – 1995 20-4
20B. CURRENT STB OVERSIGHT OF RAILROAD INDUSTRY 20-6
Jurisdiction 20-6
Exemptions 20-6
STB Oversight 20-7
CONCLUSION 20-22
APPENDIX TO CHAPTER 20 ..... 20A-1

CHAPTER 21 DESCRIPTION OF RECENT RAILROAD INDUSTRY POLICY PROPOSALS

INTRODUCTION 21-1
21A. DESCRIPTION OF POLICY CHANGES DISCUSSED IN THE GAO REPORT... 21-1
Bottleneck Rates 21-2
Reciprocal Switching 21-5
Terminal Agreements 21-7
Trackage Rights 21-9
Interchange Commitments 21-10
STB Reforms 21-15
21B. ANTITRUST REFORM 21-20
Current Antitrust Immunity for Railroads 21-20
Suggested Effects of Antitrust Immunity 21-22
The Railroad Antitrust Enforcement Act (S. 772, H.R. 1650) 21-24
Committee Hearings 21-25
21C. INVESTMENT TAX CREDIT 21-26
21D. SUMMARY OF STAKEHOLDER FEEDBACK ON POLICY PROPOSALS..... 21-28
Legislative Proposals 21-28
STB Reforms 21-29
CONCLUSION 21-30

CHAPTER 22 ECONOMIC ANALYSIS OF PROPOSED POLICY CHANGES

INTRODUCTION 22-1
22A. ASSESSMENT OF THE COMPETITIVE STATUS OF THE U.S. RAILROAD INDUSTRY 22-2
22B. ECONOMIC ANALYSIS OF SPECIFIC POLICY PROPOSALS 22-4
Open Access Proposals 22-4
Interchange Commitments 22-12
STB Reforms 22-15
Repeal Antitrust Exemptions 22-19
Investment Tax Credit 22-22
CONCLUSION 22-24

CHAPTER 23 CONCLUSIONS AND FUTURE DIRECTIONS

INTRODUCTION 23-1
23A. DISCUSSION OF STUDY'S CONCLUSIONS 23-4
Trends in Rates 23-4
Economies of Density, Market Power, and Earnings 23-5
Differential Pricing 23-6
Shipper Captivity 23-7
Capacity and Performance 23-9
Economic Analysis of Proposed Changes in Railroad Industry Policy 23-9
23B. FUTURE RESEARCH DIRECTIONS 23-10
Captivity and Effective Competition 23-11
Service Quality 23-11
Capacity 23-11
Cost Shifting 23-12
Fuel Surcharges 23-12
Issues Related to Class II and Class III Railroads 23-12
Critical Evaluation of Rail Demand Growth Projections 23-13
Reduction in Railroad Network Access 23-13

REFERENCES

ABBREVIATIONS

3-R Act	Regional Rail Reorganization Act of 1973
4-R Act	Railroad Revitalization and Regulatory Reform Act of 1976
AAR	Association of American Railroads
AFC	Average Fixed Cost
ATC	Average Total Cost
AVC	Average Variable Cost
BEA	Bureau of Economic Analysis
BLS	Bureau of Labor Statistics
the Board	Surface Transportation Board
BNSF	Burlington Northern Santa Fe
CAPM	Capital Asset Pricing Model
CBO	Congressional Budget Office
CCO	Common Carrier Obligation
CFR or C.F.R.	Code of Federal Regulations
CMP	Constrained Market Pricing
CN	Canadian National
the Commission	Interstate Commerce Commission
CP	Canadian Pacific
CSX	CSX Corporation
CWS	Carload Waybill Sample
DCF	Discounted Cash Flow
DOJ	Department of Justice
DOT	Department of Transportation
FCC	Federal Communications Commission
FDC	Fully Distributed Costing (methodology)
FTC	Federal Trade Commission
GAO	Government Accountability Office
GDP	Gross Domestic Product
ICC	Interstate Commerce Commission (also referred to as “the Commission”)
ICCTA	ICC Termination Act of 1995
KCS	Kansas City Southern
MC	Marginal Cost

MFP	Multi-Factor Productivity
NS	Norfolk Southern
PAF	Productivity Adjustment Factor
PPI	Producer Price Index
R/VC	Revenue to Variable Cost ratio
R-1	Form R-1 data from Class I railroads' Annual Reports filed with the STB
RCAF	Rail Cost Adjustment Factor
RCAF-A	Adjusted RCAF
RCAF-U	Unadjusted RCAF
RPM	Railroad Performance Measures
RPTM	Revenue per Ton-Mile
SAC	Stand-Alone Cost (methodology)
SARR	Stand-Alone Railroad (analysis)
SPLC	Standard Point Location Code
STB	Surface Transportation Board
STCC	Standard Transportation Commodity Code
TFP	Total Factor Productivity
TTX	TTX Company
UP	Union Pacific
URCS	Uniform Rail Costing System
USC or U.S.C.	United States Code
USO	Universal Service Obligation
USDA	U.S. Department of Agriculture

VOLUME 3 LIST OF FIGURES

CHAPTER 21 DESCRIPTION OF RECENT RAILROAD INDUSTRY POLICY PROPOSALS

FIGURE 21-1 GAO BOTTLENECK RATE ILLUSTRATION 21-3
FIGURE 21-2 GAO RECIPROCAL SWITCHING ILLUSTRATION 21-6
FIGURE 21-3 GAO TERMINAL AGREEMENTS ILLUSTRATION 21-8
FIGURE 21-4 GAO TRACKAGE RIGHTS ILLUSTRATION 21-10
FIGURE 21-5 GAO INTERCHANGE COMMITMENT ILLUSTRATION 21-12

CHAPTER 22 ECONOMIC ANALYSIS OF PROPOSED POLICY CHANGES

FIGURE 22-1 GAO BOTTLENECK RATE ILLUSTRATION 22-6
FIGURE 22-2 RELATIVE COSTS OF INTERCHANGE VERSUS END-TO-END MOVEMENTS 22-8

Chapter 19 Contents

CHAPTER 19 INTRODUCTION AND OVERVIEW OF VOLUME 3 19-1

19A. HISTORY OF U.S. RAILROAD LEGISLATION AND REGULATION 19-1
19B. DESCRIPTION OF RECENT RAILROAD INDUSTRY POLICY PROPOSALS..... 19-2
19C. ECONOMIC ANALYSIS OF RECENT POLICY PROPOSALS 19-2
19D. CONCLUSIONS AND DIRECTIONS FOR FUTURE RESEARCH 19-3

CHAPTER 19
INTRODUCTION AND OVERVIEW OF VOLUME 3

Volume 3 focuses on the history of public policy relating to the railroad industry policy history, recent policy proposals for the industry, and our economic analysis of these recent policy proposals. Chapter 20 and its appendix provide a description of the railroad industry's policy history and current STB responsibilities, Chapter 21 describes recent policy changes proposed for the railroad industry, Chapter 22 contains our economic analysis of the proposed policy changes described in Chapter 21, and Chapter 23 presents our conclusions and suggestions for future economic research for the railroad industry.

19A. HISTORY OF U.S. RAILROAD LEGISLATION AND REGULATION

The STB's RFP for the current study directs us to evaluate the potential policy reforms outlined in the 2006 GAO report on freight railroads, and focus on the effects these reforms would have on the railroad industry's financial health and investment incentives. The GAO also indicated the importance of evaluating the effects of policy proposals on railroad financial performance:

> It will be important for policymakers, in evaluating these alternative approaches, to carefully consider the impact of each approach on the balance set out in the Staggers Rail Act. One significant consideration is the revenue adequacy of the railroads.[1]

Chapter 20 is the first in a series of chapters that discuss railroad legislation and regulation, and the likely economic impacts on the railroad industry of proposed legislation. In Chapter 20 and its appendix, we present an overview of the legislative history concerning the railroad

[1] Government Accountability Office, *Freight Railroads: Industry Health Has Improved, but Concerns about Competition and Capacity Should Be Addressed*, GAO-07-94, October 6, 2006, p. 51. The GAO's discussions of freight railroad issues are also contained in a follow-up letter to congressional requesters dated August 15, 2007, in statements by JayEtta Hecker, GAO Director of Physical Infrastructure Issues, before the House Committee on Transportation and Infrastructure (September 25, 2007), and in Ms. Hecker's testimony before the Senate Committee on Commerce, Science, and Transportation, Subcommittee on Surface Transportation and Merchant Marine Infrastructure, Safety, and Security (October 23, 2007).

industry and the historical regulation of the industry. We then provide a description of current STB responsibilities.

19B. DESCRIPTION OF RECENT RAILROAD INDUSTRY POLICY PROPOSALS

Chapter 21 describes recent policy proposals to reform the railroad industry, many of which were discussed in the 2006 GAO report. We describe the approaches for the changes discussed in that report and proposed in recent bills before Congress—in particular S. 953 and H.R. 2125, The Railroad Competition and Service Improvement Act of 2007. The potential reforms discussed in the 2006 GAO report include changes in policies regarding: bottleneck rates, reciprocal switching, terminal agreements, trackage rights, interchange commitments (paper barriers), and the STB's procedures relating to the railroad industry. Except for the trackage rights issue, potential changes for all of these policy areas are contained in recent legislative proposals. In addition to the proposals discussed in the GAO report, we also describe other recently proposed bills that reconsider the railroad industry's antitrust exemptions (S. 772, H.R. 1650) as well as bills that propose investment tax credits for the railroad industry (S. 1125, H.R. 2116).

19C. ECONOMIC ANALYSIS OF RECENT POLICY PROPOSALS

In Chapter 22 , we present our economic analysis of the proposed policy changes. The primary focus of our economic analysis of the proposed policy changes is their effects on economic efficiency (i.e., price and output effects). Policy changes that move a market toward a more competitive market outcome (i.e., lower prices and/or greater output) improve economic efficiency (social welfare) as price decreases, output increases, and/or service improves. Policy changes most often produce winners and losers. For example, both the STB's RFP for this project and the 2006 GAO report call for an assessment of the effects of proposed policy changes on railroads' financial health and stability, and on railroad private investment incentives (as well as on shippers). In addition, as documented in Chapter 5 of this report, a number of industry stakeholders are concerned about railroad rates they consider to be too high and look to various policy changes to provide some type of rate relief. Economics can help inform who will gain and who will lose and by how much, but not whether the resulting balance of interests is advantageous or appropriate.

We base our economic analysis of proposed policy changes on our quantitative results and the most recent economic literature on railroad policy analysis. Based on our analysis in Volume 2 of this study, we first provide an overall assessment of the competitive status of the U.S. railroad industry. This assessment of the industry's structure and performance provides an initial filter for assessing the need for and likely economic

effects of the various policy proposals. Upon completing this high-level assessment, we turn to the economic analysis of specific proposed policy changes including the likely effects on economic efficiency and the potential distributional effects of the various proposals.

19D. CONCLUSIONS AND DIRECTIONS FOR FUTURE RESEARCH

Chapter 23 provides conclusions based on our research and maps out future directions for research on the U.S. freight railroad industry.

Prompted by the GAO's findings and questions, we were tasked with examining the competitive state of the U.S. freight railroad industry. In addressing this issue, we examined whether the current situation reflects reasonable economic practices by the railroads overall. Our task also involved the economic analysis of legislative proposals for changing various policies pertaining to the U.S. railroad industry, which have been introduced before Congress in recent years. In this chapter, we discuss our findings with regard to trends in railroad rates, productivity, and costs; railroad differential pricing practices; shipper captivity, railroad capacity, and performance; and the economic effects of policy changes that have been proposed by others.

In addition to the research the Christensen Associates study team performed in the course of our year-long study and our conclusions from that research, we identified a number of areas where future research efforts would improve the understanding of the U.S. freight railroad industry. Many of these potential research areas came up during the course of our stakeholder interview process but were outside the scope of the current study. For some of the issues that arose in our discussions, the current lack of adequate data prevents a thorough empirical examination at this time. We see other areas of concern as natural extensions of the research we have performed for this current study. We present a list (admittedly not exhaustive) of pertinent topics for the railroad industry that merit further investigation.

Chapter 20 Contents

CHAPTER 20 HISTORICAL AND CURRENT RAILROAD LEGISLATION AND REGULATION 20-1

INTRODUCTION 20-1
20A. LEGISLATIVE AND REGULATORY HISTORY OF THE RAILROAD INDUSTRY 20-2
Early State Regulation 20-2
Interstate Commerce Act – 1887 20-2
The “3-R” Act – 1973 20-3
The “4-R” Act – 1976 20-3
The Staggers Rail Act – 1980 20-4
The ICCTA – 1995 20-4
20B. CURRENT STB OVERSIGHT OF RAILROAD INDUSTRY 20-6
Jurisdiction 20-6
Exemptions 20-6
STB Oversight 20-7
CONCLUSION 20-22

CHAPTER 20
HISTORICAL AND CURRENT RAILROAD LEGISLATION AND REGULATION

INTRODUCTION

The STB's RFP for the current study directs us to evaluate the potential policy reforms outlined in the 2006 GAO report on freight railroads, and focus on the effects these reforms would have on the railroad industry's financial health and investment incentives. The GAO also indicated the importance of evaluating the effects of policy proposals on railroad financial performance:

> It will be important for policymakers, in evaluating these alternative approaches, to carefully consider the impact of each approach on the balance set out in the Staggers Rail Act. One significant consideration is the revenue adequacy of the railroads.[1]

This chapter is the first in a series of three chapters that discuss railroad legislation and regulation, and the likely economic impacts on the railroad industry and stakeholder groups of proposed legislation. In this chapter and its appendix, we first present an overview of the legislative history concerning the railroad industry and the historical regulation of the industry. Next, we describe the STB's current oversight responsibilities for the railroad industry. Chapter 21 provides a description of various recent proposals to alter the current market state of the railroad industry that have been enunciated by the GAO and other sources. We also provide actual language from proposed Congressional bills that would implement policy changes. Chapter 22 presents an economic analysis of these pending policy proposals.

A more detailed and fully documented overview of the legislative history concerning the railroad industry as well as the historical regulation of the industry can be found in the appendix to this chapter.

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[1] Government Accountability Office, *Freight Railroads: Industry Health Has Improved, but Concerns about Competition and Capacity Should Be Addressed,* GAO-07-94, October 6, 2006, p. 51. The GAO's discussions of freight railroad issues are also contained in a follow-up letter to congressional requesters dated August 15, 2007, in statements by JayEtta Hecker, GAO Director of Physical Infrastructure Issues, before the House Committee on Transportation and Infrastructure (September 25, 2007), and in Ms. Hecker's testimony before the Senate Committee on Commerce, Science, and Transportation, Subcommittee on Surface Transportation and Merchant Marine Infrastructure, Safety, and Security (October 23, 2007).

20A. LEGISLATIVE AND REGULATORY HISTORY OF THE RAILROAD INDUSTRY

Early State Regulation

A number of states passed laws regulating rates (setting maximum rates) and prohibiting discrimination. These states also established commissions to deal with the complicated implementation of the regulations. Constitutional challenges to these state regulations failed. A major impetus for state regulation came from an organization of farmers called the "Patrons of Husbandry" or the "Grangers." However, when railroad construction stopped following the Panic of 1873, the Grangers' influence declined and many of the states repealed the regulatory legislation, creating advisory commissions with investigatory but not regulatory powers. Market abuses returned followed by renewed state regulation.

Interstate Commerce Act – 1887

In 1887, the first independent federal agency, the Interstate Commerce Commission (ICC), was established with the passing of The Act to Regulate Commerce ("the Interstate Commerce Act"). At the time, railroads were the primary form of land transportation and railroads faced little competition from alternative modes of transportation. Before governmental regulation, there were market abuses including discrimination, preferential as well as predatory pricing practices, sale of worthless securities, and the grant of public lands and credit to railroads for valueless plans.[2] Before the passage of the Interstate Commerce Act, Congress had exercised its power to regulate railroads under its authority to regulate interstate commerce. For example the Act of June 15, 1866 authorized railroads to carry passengers and freight from one state to another and to connect with roads in other states.

The Interstate Commerce Act created the ICC and gave it powers to oversee interstate railroad commerce:

> The Commission was given the power and the duty to inquire into the management of the carriers, to require annual reports and uniform accounting, to hear complaints, and to issue cease and desist orders against carriers engaged in unlawful practices. Approximately 1200 railroad companies with 135,000 miles of track and an investment in road and equipment of $7.25 billion became subject to this law.[3]

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[2] Oren Harris, *Introduction*, 31 Geo. Wash. L. Rev. 1, 4-5 (1962-1963).

[3] Oren Harris, *Introduction*, 31 Geo. Wash. L. Rev. 1, 16 (1962-1963), citing 1 ICC Ann. Rep. 1, 2 (1887).

The act required that rates be published, just, and reasonable; shorter-haul rates could not exceed longer-haul rates under similar circumstances; and discrimination was prohibited. The pooling of freight among the railroads was prohibited. The ICC's powers were strengthened over time through numerous changes to the regulatory framework. By the 1970s,

> the Interstate Commerce Commission (ICC) reviewed almost all rail rates to determine whether they were reasonable and rail shippers were given wide latitude in selecting the routes over which their shipments would travel and the railroad companies that would participate in their traffic.[4]

In the early 1970s, railroads were in serious decline—both fiscally and physically—and had experienced a dramatic drop in traffic and market share that were lost to other modes of transportation. Blame for the crisis fell on the regulatory structures, and the deep concern over the railroad industry's decline led Congress to pass the Regional Rail Reorganization Act of 1973 ("3-R Act"), the Railroad Revitalization and Regulatory Reform Act of 1976 ("4-R Act"), and the Staggers Rail Act of 1980 (also known as the Staggers Act).

The "3-R" Act – 1973

The purpose of the 3-R Act was to replace the rail services operated by seven insolvent Class I railroads in the Midwest and Northeast regions, which were verging on cessation, with a renewed and more viable railroad system.[5] The 3-R Act created the United States Railway Association (tasked with developing and funding a system plan), the Consolidated Railway Corporation, also known as Conrail, (tasked with track acquisition and operation in the final system plan), and the Rail Services Planning Office of the ICC (tasked with holding hearings for interested parties, setting standards, and planning assistance of local rail services for the states).[6]

The "4-R" Act – 1976

The 4-R Act declared it congressional policy to:[7]

(1) balance the needs of carriers, shippers, and the public;

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[4] John Frittelli, "Railroad Access and Competition Issues," CRS Report for Congress, Order Code RL34117, updated January 10, 2008, p. 2.

[5] Regional Rail Reorganization Act of 1973, Pub. L. No. 93-236, 87 Stat. 985 (1973).

[6] Peter M. Mazer, *Assuring Adequate Rail Service: The Conflict Between Private Rights and Public Needs*, 45 Fordham L. Rev. 1429, 1440-1441 (1976-1977).

[7] Railroad Revitalization and Regulatory Reform Act of 1976, Pub. L. No. 94-210, 90 Stat. 31, 33 (1976).

(2) foster competition among all carriers by railroad and other modes of transportation, to promote more adequate and efficient transportation services, and to increase the attractiveness of investing in railroads and rail-service-related enterprises;

(3) permit railroads greater freedom to raise or lower rates for rail services in competitive markets;

(4) promote the establishment of railroad rate structures which are more sensitive to changes in the level of seasonal, regional, and shipper demand;

(5) promote separate pricing of distinct rail and rail-related services;

(6) formulate standards and guidelines for determining adequate revenue levels for railroads; and

(7) modernize and clarify the functions of railroad rate bureaus.

The Staggers Rail Act – 1980

The purpose of the Staggers Rail Act of 1980 was to "provide for the restoration, maintenance, and improvement of the physical facilities and financial stability of the rail system of the United States."[8] This act was designed "to promote a safe and efficient rail transportation system by allowing rail carriers to earn adequate revenues, as determined by the Interstate Commerce Commission."[9] Notably, the Staggers Act allowed rail carriers to establish rates without ICC interference unless the carrier had market dominance—in which case the ICC had the authority to determine if the carrier's rate was "reasonable." Congress specified a safe harbor test for market dominance—if the revenue-to-variable-cost percentage is below a certain percentage, as specified in the Act, then the rail carrier could not be found to have market dominance.[10] The Staggers Act also granted additional freedom to rail carriers in setting rates for joint routes or canceling them, although the ICC could suspend route cancellations or prescribe through routes when in "the public interest." Additionally, this act codified the ability of shippers and carriers to enter into private contracts without substantial ICC oversight.

The Staggers Act was the most far-reaching of the trio of acts passed between 1973 and 1980, and it was instrumental in bringing about a partial deregulation of the U.S. railroad industry.

The ICCTA – 1995

Fifteen years after the Staggers Act was passed, Congress terminated the Interstate Commerce Commission and vested the continued oversight of

[8] Staggers Rail Act of 1980, Pub. L. No. 96-448 § 3, 94 Stat. 1895, 1897 (1980).

[9] Staggers Rail Act of 1980, Pub. L. No. 96-448 § 101 (a), 94 Stat. 1895, 1897 (1980).

[10] Staggers Rail Act of 1980, Pub. L. No. 96-448 § 202, 94 Stat. 1895, 1900 (1980).

economic issues to the newly created Surface Transportation Board (STB). Interstate Commerce Commission Termination Act of 1995 (ICCTA) declared it U.S. policy:

> (1) to allow, to the maximum extent possible, competition and the demand for services to establish reasonable rates for transportation by rail;
>
> (2) to minimize the need for Federal regulatory control over the rail transportation system and to require fair and expeditious regulatory decisions when regulation is required;
>
> (3) to promote a safe and efficient rail transportation system by allowing rail carriers to earn adequate revenues, as determined by the Board;
>
> (4) to ensure the development and continuation of a sound rail transportation system with effective competition among rail carriers and with other modes, to meet the needs of the public and the national defense;
>
> (5) to foster sound economic conditions in transportation and to ensure effective competition and coordination between rail carriers and other modes;
>
> (6) to maintain reasonable rates where there is an absence of effective competition and where rail rates provide revenues which exceed the amount necessary to maintain the rail system and to attract capital;
>
> (7) to reduce regulatory barriers to entry into and exit from the industry;
>
> (8) to operate transportation facilities and equipment without detriment to the public health and safety;
>
> (9) to encourage honest and efficient management of railroads;
>
> (10) to require rail carriers, to the maximum extent practicable, to rely on individual rate increases, and to limit the use of increases of general applicability;
>
> (11) to encourage fair wages and safe and suitable working conditions in the railroad industry;
>
> (12) to prohibit predatory pricing and practices, to avoid undue concentrations of market power, and to prohibit unlawful discrimination;
>
> (13) to ensure the availability of accurate cost information in regulatory proceedings, while minimizing the burden on rail carriers of developing and maintaining the capability of providing such information;
>
> (14) to encourage and promote energy conservation; and

> (15) to provide for the expeditious handling and resolution of all proceedings required or permitted to be brought under this part.[11]

20B. CURRENT STB OVERSIGHT OF RAILROAD INDUSTRY

Jurisdiction

The STB has exclusive jurisdiction in the United States over:

> (1) transportation by rail carriers, and the remedies provided in this part with respect to rates, classifications, rules (including car service, interchange, and other operating rules), practices, routes, services, and facilities of such carriers; and (2) the construction, acquisition, operation, abandonment or discontinuance of spur, industrial, team, switching, or side tracks, or facilities, even if the tracks are located, or intended to be located, entirely in one State,…[12]

Exemptions

The STB has a mandate to exempt rail carrier transportation from the application of the statute "to the maximum extent consistent" with the statute when its application is not necessary to carry out the rail transportation policy, and when the railroad transaction is either limited in scope or the application of the statute is not needed to stay the abuse of market power. Under this provision, there are currently a number of active, specified exemptions. Agricultural products (except grain, soybeans, and sunflower seeds) are exempt, although carriers must continue to comply with STB accounting and reporting requirements and must maintain copies of rates, charges, rules or regulations, for traffic moved under the exemption.

In addition to agricultural products, there is a wide range of commodities that have also been exempted by STB decisions, except in instances where a finding of market dominance has been made. With regard to these miscellaneous commodities, this exemption does not affect existing regulations regarding the use of equipment and exemptions from the antitrust laws necessary to negotiate car service regulations or equipment interchange. In addition, the exemption does not relieve carriers of their obligations to comply with accounting and reporting requirements. The STB has also issued

[11] ICC Termination Act of 1995, Pub. L. No. 104–88, 109 Stat. 803, 805-806 (1995) (codified at 49 U.S.C. § 10101).

[12] 49 U.S.C. § 10501 (b).

an exemption for rail intermodal transportation. Rail transportation of new highway trailers or containers (not otherwise exempt) is exempt except for accounting and reporting requirements. There is also an exception for rail transportation in boxcars, with the following exceptions: (1) car hire and car service, (2) mandatory interchange of equipment, (3) reciprocal switching or joint use of terminal facilities, (4) car supply, and (5) freight car pooling agreements. The STB also retains jurisdiction over certain aspects of freight rates on boxcar traffic to or from an industry facility served physically by Class III carriers.

STB Oversight

Certain STB rail oversight functions are discussed under the following topics: common carrier obligations and private contracts; rates; rail construction, operation, and acquisitions; railroad abandonment; and the interchange of traffic.

Common Carrier Obligations and Private Contracts[13]

All railroads subject to STB jurisdiction have a common carrier obligation to provide the transportation or service on reasonable request. A shipper and a railroad are also authorized to enter into private contract for transportation. Before fulfilling common carrier obligations, railroads can first fulfill reasonable contract commitments. However, if the contract commitments prevent the railroad from fulfilling its common carrier obligations they are by definition not reasonable.

Common Carrier Obligations

As part of their common carrier obligations, railroads have to provide written rate and service terms upon request (including the establishment of a new rate) and provide a 20-day notice before changing these terms. With regard to agricultural (and fertilizer) products, common carrier rates, schedules of rates, and service terms as well as any scheduled changes must also be published, made available, and retained for public inspection by the railroad.

One of the STB's roles with regard to the common carrier obligations is to promulgate rules to implement the common carrier obligations, providing for the immediate disclosure and distribution of rates and service information. The rules adopted by the STB are published in the Code of Federal Regulations. The STB's rules indicate that the disclosure requirements do not apply to contracts or to any of the carriage or services to the extent they are exempted by the STB under its mandate. If, upon a complaint, the STB finds that a rail carrier is in violation of the statutes, the STB can compel its compliance.

[13] 49 U.S.C. § 11101 is entitled "Common carrier transportation, service, and rates." 49 U.S.C. § 10709 is entitled "Contracts."

The STB held a hearing on April 24 and 25, 2008, in Washington, D.C., to examine issues related to the common carrier obligation of railroads. The topics covered included service limitation resulting from a capacity constrained environment, cost and safety issues related to the transportation of hazardous materials (especially toxic inhalation hazards), carrier-imposed requirements for infrastructure investments by shippers, the impact of volume requirements or incentives, economically motivated service reductions and metering of the demand for service, the proper use of rail embargoes, abandonment authorization, and the common carrier obligation.[14]

Many issues related to the obligation of railroads to haul hazardous materials were raised at the hearing. Discussions indicated that, for many hazardous materials including toxic by inhalation hazards (TIH), rail is the safest and most efficient mode of transportation. However, according to the railroads, the transportation of these materials subjects them to ruinous liability in the event of an accident.

To allow for more detailed discussion of issues raised at its April 24, 2008 hearing, the STB held another hearing on July 22, 2008 in Washington, D.C., to examine issues related to the common carrier obligation of railroads with respect to the transportation of hazardous materials. The Board was interested primarily in specific potential policy solutions to liability issues of railroads hauling hazardous materials. In addition, there were discussions about whether there are unique costs associated with the transportation of hazardous materials and how railroads can recover these costs. Parties were also invited to comment on what constitutes a reasonable request for service involving the movement of TIH. To date, the STB has not issued any decisions regarding either the April 24-25, 2008 or the July 22, 2008 hearings.

Private Contracts

As discussed above, shippers and rail carriers are allowed by statute to enter into private contracts. The terms of the contract are confidential and govern the relationship between the parties. Judicial, not agency, relief is available for complaints regarding the interpretation or violation of private contracts.

Despite the confidentiality of private contracts, rail carriers must file a summary of non-confidential terms for each agricultural contract (or amendment thereto) within seven days of execution with the STB unless the transaction is exempted by law.

For summaries of agricultural product contracts filed with the STB, the STB can review these contracts upon a complaint by a shipper or a port filed within 18 days of the contract summary filing. Any shipper can lodge a complaint with the STB on the basis that the contract will injure the shipper

[14] *Common Carrier Obligation of Railroads*, STB Ex Parte No. 677 (STB served February 22, 2008) (STB notice of public hearing), p. 2.

because the contract will unduly impair the carrier's ability to fulfill its common carrier obligations. In addition, an agricultural commodity shipper can file a complaint if the carrier has contemporaneously unreasonably discriminated against the shipper by refusing to contract with the shipper under similar terms and conditions, or the proposed contract constitutes a destructive competitive practice. A port can file a complaint if the contract will result in unreasonable discrimination against the port. If the STB finds a violation, it will disapprove the contract and the appropriate non-contract rates/charges will apply. For discrimination complaints filed by an agricultural shipper, the STB can order the carrier to provide services to the shipper on substantially similar terms as those in the disputed contract.

Rates

The chapter of the U.S. Code governing rail rates is divided into three subchapters. The first subchapter, entitled General Authority, provides the authority and sets the standards for rates, classifications, routes, rules, and practices. The second subchapter addresses two special circumstances: government traffic and car utilization. The third subchapter covers limitations on rates. [15]

Authorizations

A rail carrier is authorized to establish any rate for transportation or other service provided by the rail carrier except where the STB has determined that a rail carrier has market dominance or where a rate is explicitly prohibited. Where the rail carrier has market dominance as determined by the STB, its rates must be reasonable. If the STB determines that the rail carrier does not have market dominance, then that finding is determinative for that rate unless changed or set aside by the Board or a court.

Rail carriers are also authorized to establish through routes with each other and water carriers, and to establish rules, provide facilities, and reasonable compensation for their operation. Through routes and the division of joint rates must be reasonable, and joint rates must be divided without unreasonable discrimination against a participating carrier. One carrier may not discriminate in its rates or in the distribution of traffic against a connecting line of another rail carrier. The STB is also authorized to prescribe through routes, joint classifications, joint rates (and the division thereof), and operational conditions when it considers it desirable in the public interest. The STB can prescribe the division of joint rates when it decides the division established by the participating carriers is unreasonable or discriminatory.

Certain limited rate agreements among rail carriers are permissible with approval by the Board and are exempted from the application of antitrust laws. The STB's approval is limited to cases where the agreement will further the

[15] 49 U.S.C. chapter 107.

rail transportation policy specified by Congress. Under the U.S. Code, an organization established under a Board-approved agreement may not allow carriers to discuss or participate in agreements related to single line rates of another carrier (except in cases such as general purpose rate increases, or broad changes in rates and practices), or interline traffic (except where the carrier is a participant). Certain limited agreements related to carrier compensation for the use of rolling stock may also be permitted with STB approval if the STB determines that the agreements will further the transportation policy.

Complaints

A rate can be challenged as being unreasonable pursuant to a complaint. The Board determines whether the carrier proposing the rate has market dominance over the transportation to which the challenged rate applies. Market dominance is defined as "an absence of effective competition from other rail carriers or modes of transportation for the transportation to which a rate applies."[16] In cases where the STB finds that a rail carrier has market dominance, it may then determine the challenged rate to be unreasonable if it exceeds a reasonable maximum. However, a finding of market dominance does not establish a presumption that the proposed rate exceeds a reasonable maximum.

Determining Market Dominance

Establishing the existence of market dominance is a prerequisite to the STB's jurisdiction to review the reasonableness of a challenged rate. The legislature has specified a "safe harbor" test for proving a lack of market dominance. The determination is made that a rail carrier does not have market dominance over the transportation to which the challenged rate applies if the rail carrier proves that the rate charged results in a revenue-variable cost percentage for that is less than 180 percent. This comparison is referred to as the quantitative test for market dominance. For the purposes of this test, variable costs of the rail carrier are determined by using the carrier's unadjusted costs, calculated using the Uniform Rail Costing System [URCS] cost finding methodology.

Even if a rail carrier's revenue-variable cost percentage is greater than 180 percent, that does not establish a presumption that the carrier has market dominance or that the challenged rate exceeds a reasonable maximum. In such a case, the STB considers whether transportation alternatives are available to the complaining shipper. This consideration is referred to as the qualitative test for market dominance.

The STB currently considers two types of competition in its qualitative market dominance analysis: intramodal and intermodal competition (where the shipper can use rail or other transportation modes to transport the same

[16] 49 U.S.C. § 10707 (b).

commodity between the same two points.) Under the qualitative test, the complaining shipper must establish the absence of both types of effective competition. The shipper can satisfy the qualitative test, even where there is some form of competition, by demonstrating that the competition is not an effective constraint on the challenged rate. In a 1981 decision, the ICC enumerated various factors for determining the degree to which there is effective competition. Evidence related to establishing the degree of intramodal competition includes:

> (1) the number of rail alternatives;
> (2) the feasibility of each alternative as evidenced by:
> (a) physical characteristics of the route associated with each alternative that are indicative of the feasibility of using that alternative for the traffic in question (e.g. circuity, track conditions, et cetera); and
> (b) the direct access of both the shipper and the receiver to each of the rail alternatives as evidenced by individual rail sidings, neutral terminal companies or reciprocal switching; or, if direct access is not available, then the feasibility of using local trucking to transport the commodity to or from terminals;
> (3) the transportation costs associated with each alternative (to determine if actual use of alternatives is due to excessive rates charged by the rail carrier in question);
> (4) collective ratemaking among the railroads in question as evidenced by rate bureau involvement; and
> (5) evidence of substantial rail-related investment or long-term supply contracts…[17]

The factors related to intermodal competition depend upon the type of transportation at issue. For water carriage, the evidence enumerated by the ICC related to establishing the degree of competition includes the number of alternatives involving different carriers, the feasibility of each alternative, and the costs of each alternative. For motor carriage, the evidence includes the amount of the product in question that is transported by motor carrier where rail alternatives are available, the amount of the product that is transported by motor carrier under transportation circumstances (e.g., shipment size and distance) similar to rail, the amount of the product that is transported using motor carrier by shippers with similar needs (distributional, inventory, et cetera) as the shipper protesting the rate, physical characteristics of the product in question that may preclude transportation by motor carrier, and the costs of the rail and motor carrier alternatives.

[17] *Market Dominance Determinations*, 365 I.C.C. 118, 132 (1981).

In 1998, the Board eliminated the consideration of two additional types of competition that had been a part of the test in determining a rail carrier's market dominance since 1981: product competition and geographic competition. Product competition is the case where the complaining shipper could avoid using the defendant railroad by shipping or receiving a substitute product. Geographic competition is the case where the complaining shipper could avoid using the defendant railroad by obtaining the same product from a different source, or by shipping the same product to a different destination. The STB concluded that the consideration of product and geographic competition significantly impeded the efficient processing of cases, having a chilling effect on the filing of valid rate complaints, and that eliminating consideration of these types of competition would have a limited impact on the rail industry.[18] There was a petition to reconsider this ruling, but the Board denied that petition in a July 1999 decision.[19]

Determining Reasonableness

Background

If the STB makes a determination that a rail carrier has market dominance over a transportation service, then the applicable rate for that transportation service must be reasonable. Where a carrier has market dominance, then in determining whether the rate is reasonable, the statute requires that the STB shall give due consideration to—

> (A) the amount of traffic which is transported at revenues which do not contribute to going concern value and the efforts made to minimize such traffic;
> (B) the amount of traffic which contributes only marginally to fixed costs and the extent to which, if any, rates on such traffic can be changed to maximize the revenues from such traffic; and
> (C) the carrier's mix of rail traffic to determine whether one commodity is paying an unreasonable share of the carrier's overall revenues, …

recognizing that rail carriers shall earn adequate revenues.[20] The STB's regulatory task is to determine whether the degree by which revenues derived from traffic exceed long-run marginal cost of handling the traffic is reasonable.

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[18] *Market Dominance Determinations,* STB Ex Parte No. 627, STB Reports, Volume 3, 1998, p. 938.

[19] *Market Dominance Determinations—Product and Geographic Competition,* STB Ex Parte No. 627, Docket No. 42022, (STB served July 2, 1999), p. 8.

[20] 49 U.S.C. § 10701 (d)(2).

Until 1996, rates were challenged as unreasonable under a Constrained Market Pricing analysis established by the ICC in 1985. As an alternative method, the simplified guidelines were established in 1996 by the STB pursuant to a legislative mandate for the establishment of a "simplified and expedited method for determining the reasonableness of challenged rail rates in those cases in which a full stand-alone cost presentation is too costly,..."[21] The process of moving to a simplified method was started by the ICC before its termination and then completed by the newly created STB.

After the simplified methods were established, time passed and no shipper filed a rate complaint using the simplified guidelines. The STB "held public hearings in April 2003 and July 2004 to examine why those guidelines had not been used by shippers and to explore ways to improve them."[22] In 2006, the Board launched two separate rulemakings—one with regard to the Constrained Market Pricing methodology, and the other with regard to the simplified guidelines. In October 2006, the STB modified its Constrained Market Pricing methodology for determining rate reasonableness in large cases, reduced the stand-alone cost analysis period to ten years, and adopted a uniform standard for reopening, vacating, and filing a new case.[23] In September 2007, the STB modified its simplified guidelines and also created a simplified stand-alone cost approach to be used in medium-sized disputes to challenge the reasonableness of rates.[24]

In October 2007, E.I. du Pont de Nemours and Company (DuPont) filed three amended complaints challenging the reasonableness of rates charged by CSX Transportation, Inc. (CSX) for seven freight rail movements.[25] DuPont proceeded under the "Three-Benchmark method" as described below, using the newly revised simplified guidelines. On June 30, 2008, the STB's decisions were delivered on the three cases, awarding DuPont up to $3 million (the maximum award of up to $1 million for each of the three freight rail complaint cases) and setting a rate prescription for six of the seven challenged movements. CSX has appealed the STB's decision to the U.S. Court of

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[21] See 49 U.S.C. § 10701 (d)(3).

[22] *Simplified Standards for Rail Rate Cases*, Ex Parte No. 646 (Sub-No. 1) (STB served September 5, 2007), p. 4; citing *Rail Rate Challenges In Small Cases*, STB Ex Parte No. 646 (STB served June 29, 2004) (notice of 2004 public hearing); *Rail Rate Challenges in Small Cases*, STB Ex Parte No. 646 (STB served Mar. 26, 2003) (notice of 2003 public hearing).

[23] *Major Issues in Rail Rate Cases*, Ex Parte No. 657 (Sub-No. 1) (STB served October 30, 2006), p. 4.

[24] *Simplified Standards for Rail Rate Cases*, Ex Parte No. 646 (Sub-No. 1) (STB served September 5, 2007), p. 1.

[25] *E.I. Dupont de Nemours & Co. v. CSX Transportation, Inc.*, STB Docket No. 42099 (STB served June 30, 2008); *E.I. Dupont de Nemours & Co. v. CSX Transportation, Inc.*, STB Docket No. 42100 (STB served June 30, 2008); *E.I. Dupont de Nemours & Co. v. CSX Transportation, Inc.*, STB Docket No. 42101 (STB served June 30, 2008).

Appeals for the District of Columbia, stating that the rate decision was "an abuse of discretion, and not supported by substantial evidence."[26]

Constrained Market Pricing

The Constrained Market Pricing (CMP) method is the primary method used by the STB for determining the reasonableness of rates. There CMP methodology has two primary approaches: a "bottom up" approach called the Stand-Alone Cost (SAC) analysis and a "top down" approach. Differential pricing and the contestability of markets are central economic tenets of Constrained Market Pricing. Differential pricing results when those shippers who are less price sensitive (e.g., captive shippers who have fewer transportation alternatives) pay more for transportation services than those who are more price sensitive (have more transportation alternatives). However, a captive shipper should not have to pay for facilities or services from which it derives no benefit (cross-subsidization). The SAC analysis provides a check on cross-subsidization. The SAC analysis has been the CMP methodology approach most frequently employed by shippers attempting to challenge the reasonableness of a rate. This approach assumes that the relevant market is a contestable market—with no barriers to entry or exit.

A SAC analysis constructs a hypothetical stand-alone railroad (SARR) and assumes this SARR provides the challenged service. This analysis includes the development of an operating plan for the SARR's traffic and services from which investment needs and operating expenses are estimated over a specified time period. The SARR's estimated revenue requirements are compared to the expected revenue generated by the traffic group—which is calculated assuming that traffic not subject to the challenge would be at the current rates. Because the analysis period is lengthy, a present value analysis is used that takes into account the time value of money, netting the annual over-recovery and under-recovery as of a common point in time. If the present value of the revenues that would be generated by the traffic group is less than the present value of the SARR's revenue requirements, then the STB concludes that the challenged rate levels do not violate the SAC constraint. If the SAC constraint is violated, however, the STB must determine the appropriate rate relief for the shipper.[27]

In the 1985 Coal Rate Guidelines, the ICC stressed that there was no one particular form for developing a SAC model, but specified the primary, required factors for any SAC analysis, including both supply and demand features.[28] On the supply side, the hypothetical SARR is designed to minimize costs and maximize efficiency, while being optimally sized. All cost data

[26] J. Boyd, *CSX Appeals DuPont Decision*, Traffic World Online, July 17, 2008, http://www.trafficworld.com/newssection/rail.asp?id=47087 (as viewed July 17, 2008).

[27] *Simplified Standards for Rail Rate Cases*, Ex Parte No. 646 (Sub-No. 1) (STB served September 5, 2007), pp. 9-10.

[28] *Coal Rate Guidelines, Nationwide*, Ex. Parte No. 347 (Sub-No. 1), 1 I.C.C. 2d 520, 543-546 (August 8, 1985).

related to the construction and operation of the hypothetical railroad must be verifiable. Indicators of required assets and potential users are given by the current carrier's facilities and customers, respectively. The SAC analysis must include a valuation of the assets composing the investment base. For this methodology, the ICC specified a valuation of assets at depreciated current costs, applying the current nominal cost of capital to the investment base in order to compute the return on investment. The SAC analysis can incorporate new as well as used assets—but it must reflect the current cost of any new asset put into use.

With regard to demand, there are no restrictions on the traffic that may be included in the SAC analysis—grouping traffic of different shippers allows the SARR to identify production economies. The revenue contribution of the traffic that is not subject to the reasonableness challenge is presumed to be at the current rates, however that presumption is rebuttable.

In 2006, the STB made several changes to the CMP methodology. The Board revised methods for the maximum rate determination, the revenue allocation for cross-over traffic, and the indexing of operating expenses. The STB also disallowed the future use of movement-specific adjustments to the URCS and shortened the SAC analysis period. In changing the way it allocated the total SAC costs to all of the SAC traffic to determine the reasonableness of the rate for the traffic at issue, the STB replaced the "percent reduction" method with the "Maximum Markup" method. Under the Maximum Markup methodology, the parties use unadjusted URCS to estimate the variable cost of each movement in the traffic group, and then determine the maximum contribution of each movement towards SAC costs, expressed as a markup over variable cost. Under this approach, a movement with a higher variable cost per ton will have a higher maximum contribution toward total SAC costs, and vice-versa.[29]

Simplified Methods

Simplified SAC. In September 2007, the STB created a simplified stand-alone cost approach for medium-sized rail disputes. The simplified SAC approach is designed to increase the accessibility of rate relief in medium-sized disputes. The simplified SAC methodology assumes that the existing infrastructure along the route used to haul the challenged traffic is required to serve the traffic on the route.

Three-Benchmark Method. The Three-Benchmark method simplified rate guidelines applying in instances where the Constrained Market Pricing guidelines cannot be practically applied for costs reasons. In September 2007, the STB amended the Three-Benchmark method guidelines that had been put

[29] *Major Issues in Rail Rate Cases*, Ex Parte No. 657 (Sub-No. 1) (STB served October 30, 2006), p. 14.

in place in 1996.[30] These guidelines apply three revenue-to-variable cost benchmark figures on a case-by-case basis: the $R/VC_{>180}$ benchmark, the RSAM benchmark; and the R/VC_{comp} benchmark.[31]

The $R/VC_{>180}$ benchmark is a first step in examining if the traffic in question comprises a disproportionate share of the carrier's revenues. This is accomplished by examining the average markups applied by the carrier to other potentially captive traffic (other traffic paying rates above the $R/VC_{>180}$ benchmark).

The RSAM (revenue shortfall allocation method) benchmark considers the rail carrier's total revenue needs—revenue sufficient to recover all of its URCS fixed costs, including a reasonable profit. The RSAM method reflects the revenue required to provide for replacing existing assets. When a carrier is not 'revenue adequate' under the Board's annual calculations, its RSAM figure (what it needs to collect) should be greater than its $R/VC_{>180}$ figure (what it is actually collecting), but when a carrier is revenue adequate under that determination, its RSAM figure should be lower than its $R/VC_{>180}$ figure.

The R/VC_{comp} benchmark measures the markups applied to similar traffic. The benchmark measures the markup taken on traffic that involves similar commodities moving under similar transportation conditions, with R/VC ratios over 180%. The rationale is to compare the R/VC ratios of like traffic (other similar, potentially captive traffic). In the amended Three-Benchmark method, each side proposes initial traffic for comparison from the Waybill Sample provided at the onset of the case. The parties meet and confer in a technical conference to attempt to resolve differences. Each of the parties then proposes a final offer concerning the traffic to be used for comparison. The Board selects the final offer that it concludes is most like the traffic at issue.

Remedies

There are two remedies available to the shipper who demonstrates that a rate is not reasonable. The shipper can receive damages, based on the shipments it made during the damages period, for the amount it overpaid. This recovery is limited in two ways. First, the statutory 180% R/VC level is considered the floor for any rate relief.[32] Second, the damages period is limited to the two-year period before the filing of the complaint.[33] The STB

[30] *Simplified Standards for Rail Rate Cases*, Ex Parte No. 646 (Sub-No. 1) (STB served September 5, 2007), pp. 16-17.

[31] R/VC stands for revenue to variable cost ratio. RSAM stands for the Revenue Shortfall Allocation Method.

[32] *E.I. Dupont de Nemours & Co. v. CSX Transportation, Inc.*, STB Docket No. 42101, p. 2 (STB served June 30, 2008), citing, *Burlington N.R.R. v. STB*, 114 F.3d 206, 210 (D.C. Cir. 1997).

[33] 49 U.S.C. § 10704 (c).

can also prescribe the maximum reasonable rate the shipper can charge for future shipments.[34]

Rail Construction, Operation, and Acquisitions[35]

Rail service that is part of an interstate rail network falls under the authorization of the STB—including extensions of existing lines, construction of additional lines, operation of a line, or acquisition (by a party other than an existing carrier which is discussed below) of a railroad line.[36] An application to authorize construction, acquisition (other than by an existing rail carrier), or operation of a rail line must be filed with the STB. The STB gives public notice of the proceedings regarding these applications. There is a legislative preference in favor of granting certification, as the certificate shall be issued unless the Board finds it is inconsistent with public convenience and necessity. However, the STB can approve the application as is or with modifications or conditions it deems necessary in the public interest. Competing railroads cannot block construction of an STB-certified activity by refusing to allow the carrier to cross its property if the carrier (either during construction or operation) does not unreasonably interfere with the operation of the crossed line and the owner of the crossed line is compensated for the crossing. If the amount of compensation is disputed by the parties, either may request the STB to make a determination of the appropriate compensation.

The STB must approve acquisitions of an extended or additional rail line by a Class II or III railroad unless it finds that the proposed activities would be inconsistent with the public convenience and necessity. However, the STB again has the power to approve the application as is or with modifications or conditions it deems necessary in the public interest.

Railroad Consolidations with/by an Existing Railroad

The STB's approval of consolidations, mergers, purchases, leases, and contracts to operate, acquisitions must be obtained in advance based on an application process that includes notice, an opportunity for comment, and a

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[34] 49 U.S.C. § 10704 (a).

[35] 49 U.S.C. § 10901, 49 U.S.C. § 10902, and 49 U.S.C. §§ 11321-11328. See also, 49 C.F.R. parts 1150 and 1180.

[36] The acquisition by a different rail carrier of an active rail line owned by a rail carrier is covered by 49 U.S.C. § 11323. There are instances where the STB's authorization is not required. The STB's authorization is not needed to repair existing track. In addition, there is an exception with regard to spur, industrial, team, switching, and side tracks. The STB does not have the authority over the construction, acquisition, operation, abandonment or discontinuance of these types of tracks. Furthermore, rail carriers can enter into agreements for joint ownership or use of said tracks without approval of the STB. 49 U.S.C. § 10906. A state's acquisition of an abandoned rail lines is not subject to the jurisdiction of the STB. See 49 C.F.R. § 1150.22. Other exemptions under 49 U.S.C. §§ 10901 and 10902 are found at 49 C.F.R. pt. 1150, subparts D [§§ 1150.31-1150.36] and E [§§ 1150.41-1150.45].

public hearing unless the Board determines this process is not in the public interest.

For any merger of at least two Class I railroads, the statutes require the Board to consider:

> (1) the effect of the proposed transaction on the adequacy of transportation to the public;
> (2) the effect on the public interest of including, or failing to include, other rail carriers in the area involved in the proposed transaction;
> (3) the total fixed charges that would result from the proposed transaction;
> (4) the interest of the rail carrier employees affected by the proposed transaction; and
> (5) whether the transaction would have an adverse effect on competition among rail carriers in the affected region or in the national rail system.[37]

Under the statute, for any proposed transaction involving the merger or control of at least two Class I railroads, the STB must approve a line sale when it finds the transaction is in the public interest—although it can place conditions upon the approval.[38] For transactions that do not involve the merger or consolidation of at least two Class I railroad, the statute stipulates:

> the Board <u>shall</u> approve such an application <u>unless</u> if finds that—(1) as a result of the transaction, there is likely to be a substantial lessening of competition, creation of a monopoly, or restraint of trade in freight surface transportation in any region of the United States; <u>and</u> (2) the anticompetitive effects of the transaction outweigh the public interest in meeting significant transportation needs.[39]

The STB developed new rules effective as of 2001 to implement the statutory requirements for the consideration and approval of mergers. The STB rules define four types of transactions: major, significant, minor, and exempt. Combinations of two or more Class I railroads are "major" transactions.[40] A significant transaction is one that would not qualify as a major transaction, although it has regional or national significance.[41] If it can be determined that

[37] 49 U.S.C. § 11324 (b).

[38] 49 U.S.C. § 11324 (c).

[39] 49 U.S.C. § 11324 (d) [emphasis added].

[40] 49 C.F.R. § 1180.2 (a).

[41] 49 C.F.R. § 1180.2 (b).

the transaction clearly will not have any anticompetitive effects or any anticompetitive effects will clearly be outweighed by the anticipated contribution to the public interest in meeting significant transportation needs, then the transaction is not classified as significant. If such a determination cannot be made, then it is classified as a significant transaction. A minor transaction is one which involves more than one railroad and which is not a major, significant, or exempt transaction. Exempt transactions meet the requirements for exemption under 49 U.S.C. § 10502, and are not subject to a merger review by the STB.

The STB's authority to review and approve mergers and combinations under is exclusive. STB-approved consolidations are not subject to challenge under the antitrust laws and from all other law, including State and municipal law, as necessary to let that rail carrier, corporation, or person carry out the transaction, hold, maintain, and operate property, and exercise control of franchises acquired through the transaction.[42]

Railroad Abandonment[43]

A rail carrier must also file an application with the STB if it plans to abandon or discontinue operations over any part of its line. The application must include a summary of the basis for the abandonment or discontinuation, a statement that interested parties are entitled to make recommendations to the STB on the future of the rail line, and a statement with information relevant to the discontinued line's availability for sale or subsidy. A rail carrier may abandon or discontinue operations on any part of its line only if the Board finds that the present or future public convenience and necessity require or permit the abandonment or discontinuance. In making that determination, the Board considers whether the abandonment or discontinuance will have a serious, adverse impact on rural and community development.

The statutes also provide a mechanism for financial assistance in the form of a subsidy for or an acquisition of the line at issue. If there are no offers from a financially responsible person or entity, then within fifteen days of the expiration of the four-month period (shorter if STB has granted an exemption), the STB can approve the application for railroad property abandonment or discontinuance as filed or with modifications, or it can deny the application if it fails to find public convenience or necessity. The STB, under specific circumstances and where public convenience and necessity require or permit it, can require a rail carrier to sell a line that has been identified by the rail carrier as subject to abandonment or discontinuance to a financially responsible person for not less than the constitutionally minimum value.

[42] 49 U.S.C. § 11321.

[43] 49 U.S.C. §§ 10903 and 10904, and 49 C.F.R. pt. 1152.

The Interchange of Traffic[44]

A rail carrier must "provide reasonable, proper and equal facilities that are within its power to provide for the interchange of traffic…."[45] Rail carriers are also authorized to establish through routes with each other and water carriers, and to establish rules, provide facilities, and reasonable compensation for their operation. The STB may only require a rail carrier to establish a through route that includes substantially less than the entire length of its railroad and any intermediate railroad operated under its management when:

> (A) required under section 10741 [prohibitions against discrimination by rail carriers], 10742 [facilities for interchange of traffic], or 11102 [use of terminal facilities] of [Title 49];
> (B) inclusion of those lines would make the through route unreasonably long when compared with a practicable alternative through route that could be established; or
> (C) the Board decides that the proposed through route is needed to provide adequate, and more efficient or economic, transportation.[46]

Rail carriers must construct, maintain, and operate, on reasonable conditions, switch connections and tracks upon the request of an owner of a lateral branch or a shipper when the connection (1) is reasonably practicable; (2) can be made safely; and (3) will furnish sufficient business to justify its construction and maintenance. If a rail carrier fails to provide a switch connection after such a request, a complaint for relief can be filed with the STB. The STB must investigate the complaint and may direct the rail carrier to provide the switch connection only after a full hearing.

Under certain circumstances, the STB may also require the use of one rail carrier's terminal facilities (and main tracks for a distance outside of the terminal) by another rail carrier. The Board may require the use of terminal facilities by another carrier where it finds such use to be practicable and in the public interest without substantially impairing the ability of the rail carrier owning the facilities or entitled to use the facilities to handle its own business. The rail carriers involved determine the compensation for such use unless they can't reach an agreement, in which case the STB may do so.

The STB may require rail carriers to enter into reciprocal switching agreements where such agreements are practicable and in the public interest, or where such agreements are necessary to provide competitive rail service. The rail carriers determine the compensation under these agreement, however if

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[44] 49 U.S.C. §§ 11102 and 11103.

[45] 49 U.S.C. § 10742.

[46] 49 U.S.C. § 10705 (a)(2).

they cannot agree then the STB may determine the compensation and conditions.

The STB has implemented rules governing petitions for through routes, through rates, and reciprocal switching. Before a rail carrier files for a STB-prescribed through route, joint rate, or reciprocal switching, it must first attempt negotiations with the rail carrier in question. Parties may use arbitration in the negotiation process. The STB will prescribe a through route, through rate, or switching arrangement if it is necessary to remedy or prevent anticompetitive activities and the complaining party had or would use the through route, through rate, or reciprocal switching for a significant amount of its traffic (rail carrier) or transportation needs (shipper). In determining the potential anticompetitive impact, the Board considers all relevant factors including the revenues of the railroads involved, the efficiency of the rail routes involved (including operating costs), rates or compensation charged by the rail carrier from whom the prescription is being sought, and the revenue, cost, and the ratio thereof for the traffic that would result.

If, upon a complaint, the STB finds that a rail carrier is in violation of the statutes, the STB can compel its compliance. Under certain circumstances, the Board can also prescribe alternative rail service for a rail carrier's failures upon a specific, detailed petition for relief from shippers or other rail carriers. The Board can prescribe alternative rail service when it makes a determination that over an identified period of time, there has been a substantial, measureable deterioration or other demonstrated inadequacy in rail service provided by the incumbent carrier. If relief is granted and the STB prescribes alternative services, the incumbent rail carrier may file to terminate the relief with evidence demonstrating that it is prepared to meet the statutory service requirements.

A number of cases, referred to as the "bottleneck" cases, have been filed by shippers seeking relief for service routes involving a bottleneck segment—where a portion of the route is served by multiple carriers, but some bottleneck segment of the route is served by only one carrier—to counter what the shippers perceived as the bottleneck carriers' undue market power over shipments.

In *Central Power & Light Co. v. Southern Pacific Transportation Co., et al.,* [47] the STB refused to order the rail carrier to establish a local rate for the bottleneck segment. In acknowledging its duty to assist rail carriers to earn adequate revenues, the Board recognized that a rail carrier's ability to implement differential pricing is necessary to earn adequate revenues, thus the Board declined to prescribe a local rate for the captive shippers.

The Board also refused to order the bottleneck carriers to establish such a rate from an interchange point of the shipper's choosing, stating that "through

[47] *Central Power & Light Co. v. Southern Pacific Transportation Co., et al.,* STB Docket No. 41242 et al., Decision (STB served December 27, 1996).

the [4-R Act] and the [Staggers Act], Congress ended the 'open-routing' system that effectively had required rail carriers to establish and maintain interchanges and through routes 'on practically all combinations of railroad tracks between two points.'"[48] The Board concluded that the shippers did not fulfill their obligation to show that a carrier has used its market power to extract unreasonable terms on through movements, or shown a disregard for the shipper's needs by rendering inadequate service.

CONCLUSION

This chapter provided an overview of the historical and current regulation of the railroad industry, including the STB's current oversight responsibilities and rulemaking. The appendix to this chapter covers the same material in greater detail and with additional documentation. Chapter 21 addresses proposed policy changes and the current legislative initiatives designed to implement a number of these changes. The economic impacts of these potential policy changes are discussed in Chapter 22.

[48] *Central Power & Light Co. v. Southern Pacific Transportation Co., et al.*, STB Docket No. 41242 et al., Decision (STB served December 27, 1996), p. 6; citing, *Baltimore Gas & Electric Co. v. United States*, 817 F.2d at 110 (D.C. Cir. 1987).

APPENDIX 20A TABLE OF CONTENTS

APPENDIX 20A HISTORICAL AND CURRENT RAILROAD LEGISLATION AND REGULATION 20A-1

INTRODUCTION 20A-1
20A SECTION A. LEGISLATIVE AND REGULATORY HISTORY OF THE RAILROAD INDUSTRY 20A-1
State Regulation 20A-2
Federal Regulation 20A-2
The Interstate Commerce Commission (ICC) 20A-3
20A SECTION B. CURRENT STB OVERSIGHT OF RAILROAD INDUSTRY 20A-19
Organization of the Relevant Portion of the United States Code 20A-19
STB Oversight 20A-22

Appendix 20A
HISTORICAL AND CURRENT RAILROAD LEGISLATION AND REGULATION

INTRODUCTION

This appendix provides a more detailed account of the U.S. railroad industry's legislative and regulatory history, and describes the STB's current responsibilities. It covers the same topics discussed in Chapter 20 while providing more extensive documentation of legislative and regulatory actions.

SECTION A. LEGISLATIVE AND REGULATORY HISTORY OF THE RAILROAD INDUSTRY[1]

The history of railroad regulation and the ensuing economic results reflect changes in both the marketplace as well as policy priorities. The changing nature of U.S. transportation priorities, as reflected in legislation, was described on the 75th anniversary of the creation of the ICC as

> a record of vacillation and inconsistency on the basic issue of the proper role of competition in transportation. The recurring transportation crises which have been experienced over the seventy-five year history of federal transportation regulation are in substantial part the result of this failure to develop and effectuate sound public policies to govern transportation competition. Blame for the failure must be divided, as responsibility has been, among carrier managements, the Commission, the Congress, and the courts.[2]

In 1887, the Interstate Commerce Commission was established as the first independent federal agency in the U.S. with the passage of The Act to

[1] In honor of the 50th and 75th anniversary of the creation of the Interstate Commerce Commission (ICC), the George Washington Law Review published papers from commemorative symposia on the ICC. The information through 1963 contained in this section, unless otherwise specifically noted, is gathered from various articles in the commemorative publications found at 5 Geo. Wash. L. Rev. (1936-1937) and 31 Geo. Wash. L. Rev. (1962-1963).

[2] Eugene Liipfert, *Consolidation and Competition in Transportation: The Need for an Effective and Consistent Policy*, 31 Geo. Wash. L. Rev. 106, 108 (1962-1963).

Regulate Commerce ("the Interstate Commerce Act"). At the time, railroads were the primary form of land transportation and they faced little competition from alternative modes of transportation. Before governmental regulation, there were market abuses in the railroad industry including discrimination, preferential and predatory pricing practices (such as secret rebating and special contracts), price gouging, sale of worthless securities, and the grant of public lands and credit to railroads for valueless plans.[3]

State Regulation

Prior to the enactment of the Interstate Commerce Act, a number of states passed laws regulating railroad rates (setting maximum rates) and prohibiting discrimination. These states also established commissions to deal with the complexities of implementing their regulations. Constitutional challenges to these state regulations failed. A major impetus for state regulation came from an organization of farmers called the "Patrons of Husbandry" or the "Grangers." However, when railroad construction came to a standstill following the Panic of 1873, the Grangers' influence declined and many of the states repealed their regulatory legislation, creating advisory commissions with investigatory but not regulatory powers. Market abuses returned and were followed by renewed state regulation. An impetus for federal regulation emanated from a U.S. Supreme Court decision striking down an Illinois law that attempted to regulate the intrastate portion of interstate rail traffic in October 1886.[4] The Court's opinion affected most of the rail traffic at that time.[5]

Federal Regulation

Before the passage of the Interstate Commerce Act, Congress had exercised limited power in the regulation of railroads under its authority to regulate interstate commerce. For example, the Act of June 15, 1866, authorized railroads to carry passengers and freight from one state to another and to connect with roads in other states.

The Interstate Commerce Act resulted from a legislative compromise between the Senate and House. The Senate had created a committee in March 1885, to study the regulation of interstate transportation (the Cullom Committee). At the same time, the House had been considering its own bill to regulate railroads. Both houses passed their disparate bills in the first congressional session of 1886, but initial attempts to craft a compromise bill

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[3] Oren Harris, *Introduction*, 31 Geo. Wash. L. Rev. 1, 4-5 (1962-1963).

[4] Clyde Aitchison, *The Evolution of the Interstate Commerce Act: 1887-1937*, 5 Geo. Wash. L. Rev. 289, 300 (1936-1937), citing *Wabash, St. L. & P. R. Co. v. Illinois*, 118 U. S. 557, 7 Sup. Ct. 4, 30 L. ed. 244 (1886).

[5] Clyde Aitchison, *The Evolution of the Interstate Commerce Act: 1887-1937*, 5 Geo. Wash. L. Rev. 289, 300 (1936-1937).

failed before the end of the session. Among the major differences between the Senate and House bills, the Senate bill adopted the Cullom Committee's recommendation to create a commission for regulating railroads, while the House bill provided for judicial remedies. After the Supreme Court's October 1886 decision in *Wabash et al. v. Illinois*, the Senate and House agreed to a compromise bill that included the establishment of the Interstate Commerce Commission.

The Interstate Commerce Commission (ICC)

The Interstate Commerce Act established the ICC and gave it the power to oversee interstate railroad commerce.

> The Commission was given the power and the duty to inquire into the management of the carriers, to require annual reports and uniform accounting, to hear complaints, and to issue cease and desist orders against carriers engaged in unlawful practices. Approximately 1200 railroad companies with 135,000 miles of track and an investment in road and equipment of $7.25 billion became subject to this law.[6]

This act required the publication of railroad rates. With regard to rates, it also stated, "All charges made for any service rendered or to be rendered…shall be reasonable and just; and every unjust and unreasonable charge for such service is prohibited and declared to be unlawful."[7] Under this act, shorter-haul rates could not exceed longer-haul rates "under substantially similar circumstances and conditions…over the same line, in the same direction, the shorter being included within the longer distance…"[8] Discrimination, special rates, rebates and the pooling of freight among railroads were also prohibited.

Judicial interpretation of the Interstate Commerce Act limited certain regulatory provisions. For example, the Supreme Court upheld a lower court's ruling against the ICC in a case where the ICC was seeking enforcement of its order against Alabama Midland prescribing certain short-haul rates in excess of long-haul rates for like products over the same track in the same direction.[9] The Supreme Court interpreted the statutory language regarding "under substantially similar circumstances and conditions" as requiring consideration of competition. The Court stated, "That competition is one of the most obvious

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[6] Oren Harris, *Introduction*, 31 Geo. Wash. L. Rev. 1, 16 (1962-1963), citing 1 ICC Ann. Rep. 1, 2 (1887).

[7] An Act to Regulate Commerce, ch. 104, § 1, 24 Stat. 379, 379 (1887).

[8] An Act to Regulate Commerce, ch. 104, § 4, 24 Stat. 379, 380 (1887).

[9] *Interstate Commerce Commission v. Alabama Midland Ry. Co.*, 168 U.S. 144 (1897).

and effective circumstances that make the conditions, under which a long and short haul is performed, substantially dissimilar, and as such must have been in the contemplation of Congress in the passage of the act to regulate commerce, has been held by many of the Circuit Courts."[10] In this instance, the Supreme Court determined that competition affecting rates must be considered in determining violations under the long- and-short-haul clause. The Supreme Court stated:

> The volume of trade to be competed for, the number of carriers actively competing for it, and a constantly open river present to take a large part of it whenever the railroad rates rise up to the mark of profitable water carriage, seem to us, as they did to the Circuit Court, to constitute circumstances and conditions at Montgomery [long-haul] substantially dissimilar from those existing at Troy [short-haul], and to relieve the carriers from the charges preferred against them by [Troy].[11]

Another Supreme Court decision in 1897 interpreted the Interstate Commerce Act as limiting the ICC's power to pass on the reasonableness of rates to only historical rates.[12] In response to these judicial decisions, Congress enacted numerous changes to the regulatory framework in order to reinforce the ICC's regulatory powers.

The Hepburn Act of 1906 was a significant legislative response to earlier judicial decisions.[13] The Hepburn Act extended the Interstate Commerce Act's regulation of commerce to pipelines, and expanded the definition of the term "railroad" to include switches, spurs, tracks, and terminal facilities. The Hepburn Act also required that carriers subject to the Interstate Commerce Act "provide and furnish such transportation upon reasonable request therefore, and to establish through routes and just and reasonable rates applicable thereto."[14] The ICC was empowered, upon complaint, to establish through routes, set maximum joint rates, and determine the division of joint rates when necessary to effectuate the purpose of the Interstate Commerce Act. Despite these amendments, the ICC's 1909 report to Congress suggested the agency believed additional changes were still needed.

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[10] *Interstate Commerce Commission v. Alabama Midland Ry. Co.*, 168 U. S. 144, 164 (1897).

[11] *Interstate Commerce Commission v. Alabama Midland Ry. Co.*, 168 U. S. 144, 172 (1897).

[12] Clyde Aitchison, *The Evolution of the Interstate Commerce Act: 1887-1937*, 5 Geo. Wash. L. Rev. 289, 322 (1936-1937), citing *Interstate Commerce Commission v. Cincinnati, N. O. & T. P. Ry. Co. (Maximum Rate Case)*, 167 U. S. 479, 17 Sup. Ct. 896, 42 L. ed. 243 (1897).

[13] The Hepburn Act, 34 Stat 584 (1906).

[14] The Hepburn Act, § 1, 34 Stat 584, 584 (1906).

The Mann-Elkins Act (1910) eliminated the "under substantially similar circumstances and conditions" language of the short-haul/long-haul section of the Interstate Commerce Act and prohibited a rail carrier from charging "any greater compensation as a through route than the aggregate of the intermediate rates…"[15] Furthermore, this act expanded the railroads' obligations with regard to through routes, requiring a carrier "to provide reasonable facilities for operating such through routes and to make reasonable rules and regulations with respect to the exchange, interchange, and return of cars used therein, and for the operation of such through routes, and providing for reasonable compensation to those entitled thereto."[16] In cases where a rail carrier lowered rates to compete with a water route, "it [would] not be permitted to increase such rates unless after hearing by the [ICC] it [was] found that such proposed increase [rested] upon changed conditions other than the elimination of water competition."[17] For newly filed rates, the Commission could, either upon complaint or under its own initiative, hold a rate hearing, and in the interim it could suspend the implementation of said rate for a period of not longer than 120 day (with another 60 days thereafter at its discretion). In the rate hearing before the ICC, "the burden of proof to show that the increased rate or proposed increased rate is just and reasonable [would] be upon the common carrier …"[18]

The Mann-Elkins Act also created the United States Commerce Court.[19] The Commerce Court had jurisdiction to enforce or enjoin ICC orders, and its decisions were appealed directly to the Supreme Court. "The [Commerce] Court speedily came into sharp conflict with the Commission. In the Supreme Court the Commerce Court fared badly: repeatedly the action of the Commerce Court in reversing the Commission was itself [sic] reversed on appeal to the Supreme Court, and the reversals continued, even after the abolition of the Commerce Court."[20] The Commerce Court existed for only a few years and was abolished in 1913.[21]

The Clayton Act (1914) vested enforcement of its limitations on anticompetitive behavior, or acquisitions that would lessen competition, with the ICC for carriers subject to the Interstate Commerce Act.

In 1917 during World War I, the federal government seized control of the railroad operations that were plagued by car shortages, and allocation and

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[15] The Mann-Elkins Act, § 8, 36 Stat. 539, 547 (1910).

[16] The Mann-Elkins Act, § 7, 36 Stat. 539, 545 (1910).

[17] The Mann-Elkins Act, § 8, 36 Stat. 539, 548 (1910).

[18] The Mann-Elkins Act, § 12, 36 Stat. 539, 552 (1910).

[19] The Mann-Elkins Act, § 1, 36 Stat. 539, 539 (1910).

[20] Clyde Aitchison, *The Evolution of the Interstate Commerce Act: 1887-1937*, 5 Geo. Wash. L. Rev. 289, 340 (1936-1937).

[21] Act approved October 22, 1913, Pub. L. No. 63-32, 38 Stat. 208, 219 (1913).

distribution problems. "Rates and wages were raised, facilities were augmented, and the traffic congestion gradually relieved. For the first time an effort was made to operate the railroad network as a national system."[22]

The Transportation Act of 1920 provided for "the termination of Federal control of railroads and systems of transportation…."[23]

> [The Transportation Act of 1920] was the first completed legislative attempt to deal comprehensively with the interrelations of all the parties to the transportation service—carrier, shipper, labor and government—on a basis other than merely prohibition and correction...A central feature of the new policy was embraced in the rule of rate-making and recapture provisions…[24]

This act attempted to address some of the disparities among carriers and geographic regions.

> The focus of concern, at a time of railroad domination of inland transportation, became the maintenance of an adequate and financially healthy transportation system. Because of the disparate earning power of the individual roads, the regulation of the level of rates had become a particularly thorny problem. Return on investment constituted the basic approach of the rate regulation of the day, and it was deemed necessary that competitive roads maintain a common level of rates within the various rate territories. A level of rates sufficiently high to afford an adequate rate of return to the 'weak' roads would have resulted in excessive returns to stronger railroad companies. The consolidation provisions of the Transportation Act of 1920 were bottomed on the premise that balanced regional rail systems incorporating both the weak and strong roads would permit application of a common level of rates within regions and among competing systems of relatively equal earning power, producing reasonable rates of return for each system and fostering financial health and adequacy of service. If the

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[22] Eugene Liipfert, *Consolidation and Competition in Transportation: The Need for an Effective and Consistent Policy*, 31 Geo. Wash. L. Rev. 106, 112 (1962-1963), citing Sharfman, *The Interstate Commerce Commission* 71-103 (1931).

[23] Transportation Act of 1920, Pub. L. No. 66-152, 41 Stat. 456, 456 (1920).

[24] Clyde Aitchison, *The Evolution of the Interstate Commerce Act: 1887-1937*, 5 Geo. Wash. L. Rev. 289, 358-359 (1936-1937), citing *Dayton-Goose Creek Ry. Co. v. ICC*, 263 U.S. 456 (1924).

> balance were not properly struck, recapture provisions were provided by which excessive earnings could be recouped and applied for the benefit of those roads whose earnings were deficient.[25]

This act also considerably expanded the ICC's rate-setting powers:

> Under the Transportation Act of 1920 the Commission was empowered to set maximum and minimum rates as well as to prescribe rates. The Interstate Commerce Act required the railroads to file every change in rates between any two points or for any commodity. The Commission could suspend any change which it suspected might be unjust or unreasonable. Any rate which it later found to be unjust or unreasonable was unlawful. If the rates had been too high, refunds had to be made to any shipper who could prove that he had paid the unlawful rate.[26]

The rationale for setting maximum rates was to protect shippers from abuses of market power by rail carriers, while setting minimum rates would protect rail carriers from rate wars and other forms of competition deemed harmful.

As a result of this act, the ICC played a role in industry entry, exit, and expansion. The act required a certificate from the ICC avowing a "present or future public convenience and necessity" in order to construct, extend, acquire, or abandon a rail line.[27] Under this act, the ICC could also, upon petition or its own initiative, order a rail carrier to "provide itself with safe and adequate facilities" and "to extend its line or lines" if the ICC found it in the interest of public convenience and necessity.[28]

The Transportation Act of 1920 also tasked the Commission with creating a plan of railroad consolidation that would preserve competition and maintain routes to the extent possible, and such that the costs and property values between competing systems under the plan would be comparable. Weak

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[25] Eugene Liipfert, *Consolidation and Competition in Transportation: The Need for an Effective and Consistent Policy*, 31 Geo. Wash. L. Rev. 106, 113 (1962-1963); citing Transportation Act of 1920 § 422, 41 Stat. 488 (1920).

[26] Forrest N. Krutter, *The Railroad Revitalization and Regulatory Reform Act of 1976: Improving the Railroads' Competitive Position*, 14 Harv. J. on Legis. 575, 584 (1976-1977), citing 41 Stat. 485 (1920), 49 U.S.C. § 6(3) (1970), 49 U.S.C. § 13(1) (1970), and 49 U.S.C. § 15(7) (1970).

[27] Transportation Act of 1920, Pub. L. No. 66-152, § 402, 41 Stat. 456, 477 (1920).

[28] Transportation Act of 1920, Pub. L. No. 66-152, § 402, 41 Stat. 456, 478 (1920).

systems could merge with stronger ones and create stronger rail carriers.[29] Once the consolidation was completed, railroad carriers would be allowed to merge with other carriers if consistent with the plan. The ICC commissioned a consolidation plan from William Z. Ripley, a professor of political economy at Harvard University, known as the Ripley Plan. While the ICC published the Ripley Plan under the title Complete Plan of Consolidation in 1929, none of the proposed mergers ever occurred.[30]

Under the Transportation Act of 1920, acquisitions (through lease or stock purchase, but not a consolidation) were permitted with ICC authority "for such consideration and on such terms and conditions as might be just and reasonable."[31] The ICC, under the authority of this act, allowed acquisitions during this time period—changing the picture of railroad competition from that of the Ripley Plan—"render[ing] the possibility of voluntary consolidations in accordance with the final consolidation plan less likely."[32]

The 1920 act also established a railroad contingency fund financed by payments from rail carriers earning above a certain level (a "fair return") of net railway operating income. The ICC had the duty to

> initiate rates that, as nearly as might be, would earn a fair return. Carriers were held as trustees for one-half of the excess above 6 per cent in net railway operating income, and this amount was to be recapturable by the Commission, to be put into a revolving fund, to be loaned so as to enable carriers to make improvements to rail properties which were in the public interest, but which promised no immediate return of revenue.[33]

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[29] The intended results were met with resistance from the stronger lines that were wary of taking on the financial and other liabilities of the weaker lines. In later years, the ICC was criticized for not acting promptly to approve some proposed mergers when weaker railroads ended up failing before the proposed mergers could be approved. Forrest N. Krutter, *The Railroad Revitalization and Regulatory Reform Act of 1976: Improving the Railroads' Competitive Position*, 14 Harv. J. on Legis. 575, 579-580 (1976-1977).

[30] Office of Technology Assessment, United States Congress, *A Review of National Railroad Issues*, Appendix B: Review of Recent Railroad Mergers, 1975, p. B-2.

[31] Clyde Aitchison, *The Evolution of the Interstate Commerce Act: 1887-1937*, 5 Geo. Wash. L. Rev. 289, 363 (1936-1937). The Emergency Railroad Transportation Act (1933) required consistency with the consolidation plan of all ICC-approved acquisitions as well as consolidations. Emergency Railroad Transportation Act, 1933, 48 Stat. 211, 217 (1933).

[32] Eugene Liipfert, *Consolidation and Competition in Transportation: The Need for an Effective and Consistent Policy*, 31 Geo. Wash. L. Rev. 106, 114 (1962-1963).

[33] Clyde Aitchison, *The Evolution of the Interstate Commerce Act: 1887-1937*, 5 Geo. Wash. L. Rev. 289, 359 (1936-1937), citing *Dayton-Goose Creek Ry. Co. v. ICC*, 263 U.S. 456 (1924). See also Transportation Act of 1920, Pub. L. No. 66-152, § 422, 41 Stat. 456, 489 (1920).

The fund was designed to be used as a revolving fund, for making loans available to carriers by application. This fund proved to be administratively complex.[34] It was dissolved during the Great Depression and the fund's assets were returned to those carriers that had made payments. In its stead, the ICC, in the exercise of its power to set rates, was required to give

> due consideration, among other factors, to the effect of rates on the movement of traffic; to the need, in the public interest, of adequate and efficient railway transportation service at the lowest cost consistent with the furnishing of such service; and to the need of revenues sufficient to enable the carriers, under honest, economical, and efficient management, to provide such service.[35]

The Transportation Act of 1920 did not function as envisioned in the face of "economic changes, resultant from the World War, which could not have been foreseen, and which made some of its important provisions impossible or economically unsound."[36] The Great Depression strained the financial viability of even the strongest railroads and the resulting economic conditions were not conducive to consolidation.[37] In addition, during this time frame railroads began to experience competition from motor vehicles, due to the development of highways, as well as water carriers.[38]

The Transportation Act of 1940 reflected a continuation of the shift in policy away from focusing on ending carrier market abuses and providing reasonable and non-discriminatory rates for shippers, to a concern with the economic viability of a rail system in the face of varying market circumstances. This act contained an explicit statement of the national transportation policy:

> It is hereby declared to be the national transportation policy of the Congress to provide for fair and impartial regulation of all modes of transportation subject to the provisions of this Act, so administered as to recognize and preserve the inherent advantages of each; to promote safe,

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[34] Clyde Aitchison, *The Evolution of the Interstate Commerce Act: 1887-1937*, 5 Geo. Wash. L. Rev. 289, 359 (1936-1937).

[35] Emergency Railroad Transportation Act, 1933, Pub. L. No. 73-68, 48 Stat. 211, 220 (1933).

[36] Clyde Aitchison, *The Evolution of the Interstate Commerce Act: 1887-1937*, 5 Geo. Wash. L. Rev. 289, 375 (1936-1937).

[37] Eugene Liipfert, *Consolidation and Competition in Transportation: The Need for an Effective and Consistent Policy*, 31 Geo. Wash. L. Rev. 106, 114 (1962-1963).

[38] In 1935, the Motor Carrier Act subjected motor vehicle transportation to similar regulation under the ICC. Traffic on waterways was regulated under the Transportation Act of 1940. Eugene Liipfert, *Consolidation and Competition in Transportation: The Need for an Effective and Consistent Policy*, 31 Geo. Wash. L. Rev. 106, 115 (1962-1963).

> adequate, economical, and efficient service and foster sound economic conditions in transportation and among the several carriers; to encourage the establishment and maintenance of reasonable charges for transportation services, without unjust discriminations, undue preferences or advantages, or unfair or destructive competitive practices; to cooperate with the several States and the duly authorized officials thereof; and to encourage fair wages and equitable working conditions; —all to the end of developing, coordinating, and preserving a national transportation system by water, highway, and rail, as well as other means, adequate to meet the needs of the commerce of the United States, of the Postal Service, and of the national defense. All of the provisions of this Act shall be administered and enforced with a view to carrying out the above declaration of policy.[39]

"[U]nder the changed conditions, the objective of consolidation came to be the enhancement of economy and efficiency, rather than the facilitation of uniform rate regulation."[40] The railroad consolidation plan was abandoned. The 1940 act called for the ICC to consider merger proposals on the merits, in light of the following criteria:

> (1) the effect of the proposed transaction upon adequate transportation service of the public; (2) the effect upon the public interest of the inclusion, or failure to include, other railroads in the territory involved in the proposed transaction; (3) the total fixed charges resulting from the proposed transactions; and (4) the interest of the carrier employees affected.[41]

During the 1950s, railroads continued to experience financial difficulties. A cabinet level committee, the Weeks committee, was established to delve into U.S. transportation policy, primarily focusing on the Interstate Commerce Act. This committee's 1955 report

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[39] Transportation Act of 1940, Pub. L. No. 76-785, § 1, 54 Stat. 898, 899 (1940).

[40] Eugene Liipfert, *Consolidation and Competition in Transportation: The Need for an Effective and Consistent Policy*, 31 Geo. Wash. L. Rev. 106, 115 (1962-1963).

[41] Office of Technology Assessment, United States Congress, *A Review of National Railroad Issues*, Appendix B: Review of Recent Railroad Mergers, 1975, p. B-2. The 1940 act also contained major provisions for the regulation of water carriers. See Leslie Bryan, *Transportation Legislation of 1940*, 9 Am. L. Sch. Rev. 1118, 1121 (1938-1942).

> stirred immediate controversy, for it focused attention upon price regulation as a major weakness in the transport system. The committee felt that the principles developed by the Commission over the years and accepted by the regulated carriers in their pricing policies were responsible for (1) the growth of unregulated transport and the decline of the regulated segment and (2) a costly misallocation of traffic among several modes of carriage, with the result that the nation's transport bill was substantially larger than necessary.[42]

The Weeks committee advocated an increased role for competition and a decreased role for regulation—"competition should be accorded greater latitude and …regulation should be relaxed."[43]

A few years later Congress passed the Transportation Act of 1958. This act did not deregulate rates, but with the increase in intermodal competition for shipments, the Transportation Act of 1958 instructed the ICC

> in determining whether a rate is lower than a reasonable minimum rate, [the ICC] shall consider the facts and circumstances attending the movement of the traffic by the carrier or carriers to which the rate is applicable. Rates of a carrier shall not be held up to a particular level to protect the traffic of any other mode of transportation, giving due consideration to the objectives of the national transportation policy declared in this Act.[44]

The national transportation policy as enacted by the Transportation Act of 1940 required that the statute be "administered as to recognize and preserve the inherent advantages of each" mode of transportation. The Supreme Court interpreted the legislative requirement that the ICC give due consideration to the national transportation policy as requiring that the ICC "protect transportation modes with an inherent advantage (as measured by, for example, service and cost) from destruction by the railroads."[45] Railroads faced

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[42] Ernest W. Williams, Jr., *Transportation Prices: Their Initiation and Regulation*, 50 Va. L. Rev. 377, 384 (1964) citing *Presidential Advisory Comm. On Transport Policy and Organization, Revision of Federal Transportation Policy* (1955).

[43] Ernest W. Williams, Jr., *Transportation Prices: Their Initiation and Regulation*, 50 Va. L. Rev. 377, 385 (1964).

[44] Transportation Act of 1958, Pub. L. No. 85-625, § 6, 72 Stat. 568, 572 (1958).

[45] Forrest N. Krutter, *The Railroad Revitalization and Regulatory Reform Act of 1976: Improving the Railroads' Competitive Position*, 14 Harv. J. on Legis. 575, 590 (1976-1977), citing *ICC v. New York, N.H. & H. R.R.*, 372 U.S. 744 (1963), *vacating and remanding* 199 F. Supp. 635 (D. Conn. 1961), *reversing* Commodities—Pan-Atlantic S.S. Corp., 313 I.C.C. 23 (1960).

increasing competition from other modes of transportation and experienced declining traffic.[46]

By the 1970s, "the Interstate Commerce Commission (ICC) reviewed almost all rail rates to determine whether they were reasonable and rail shippers were given wide latitude in selecting the routes over which their shipments would travel and the railroad companies that would participate in their traffic."[47]

The U.S. had "a regulatory system that precluded rate competition among rail carriers, because *all* rates between a particular origin and destination were the same on *all* routes."[48] At this time, railroads were in serious decline—both fiscally and physically—and had experienced a dramatic drop in traffic and market share lost to other modes of transportation. Blame for the crisis fell on the regulatory structures. "[I]t is not an overstatement to say that this archaic Federal regulatory structure played a major role in the ultimate financial collapse in the 1970's of a significant portion of the rail industry in the United States. In the Northeast, seven railroads filed for bankruptcy…In the Midwest, two major carriers…also fell victim to bankruptcy…"[49] Concern over the decline led Congress to pass the Regional Rail Reorganization Act of 1973 ("3-R Act"), the Railroad Revitalization and Regulatory Reform Act of 1976 ("4-R Act"), and the Staggers Rail Act of 1980 (also known as the Staggers Act), which I discuss below. [50]

The purpose of the 3-R Act was "to salvage the rail services operated by seven insolvent Class I railroads in the Midwest and Northeast region of the Nation, which are threatened with cessation, by replacing them with a new and viable rail services system."[51] To implement this new system, the act created the United States Railway Association (tasked with developing and funding a system plan), the Consolidated Railway Corporation, also known as Conrail, (tasked with track acquisition and operation in the final system plan), and the Rail Services Planning Office of the ICC (tasked with holding hearings for

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[46] Forrest N. Krutter, *The Railroad Revitalization and Regulatory Reform Act of 1976: Improving the Railroads' Competitive Position*, 14 Harv. J. on Legis. 575, 575-579 (1976-1977).

[47] John Frittelli, "Railroad Access and Competition Issues," CRS Report for Congress, Order Code RL34117, updated January 10, 2008, p. 2.

[48] G. Kent Woodman and Jane Starke, *The Competitive Access Debate: A "Backdoor" Approach to Rate Regulation*, 16 Transp. L.J. 263, 266 (1987-1988) [emphasis in original].

[49] G. Kent Woodman and Jane Starke, *The Competitive Access Debate: A "Backdoor" Approach to Rate Regulation*, 16 Transp. L.J. 263, 268 (1987-1988).

[50] Regional Rail Reorganization Act of 1973, Pub. L. No. 93-236, 87 Stat. 985 (1973); Railroad Revitalization and Regulatory Reform Act of 1976, Pub. L. No. 94-210, 90 Stat. 31, (1976); and Staggers Rail Act of 1980, Pub. L. No. 96-448, 94 Stat. 1895, (1980).

[51] Regional Rail Reorganization Act of 1973, Pub. L. No. 93-236, 87 Stat. 985 (1973).

interested parties, setting standards, and planning assistance of local rail services for the states).[52]

The purpose of the 4-R Act was "to provide the means to rehabilitate and maintain the physical facilities, improve the operations and structure, and restore the financial stability of the railway system of the United States, and to promote the revitalization of such railway system, so that this mode of transportation will remain viable in the private sector…"[53] This purpose was to be accomplished through, among other means, ratemaking and regulatory reform. The 4-R Act declared it congressional policy to:

> (1) balance the needs of carriers, shippers, and the public;
> (2) foster competition among all carriers by railroad and other modes of transportation, to promote more adequate and efficient transportation services, and to increase the attractiveness of investing in railroads and rail-service-related enterprises;
> (3) permit railroads greater freedom to raise or lower rates for rail services in competitive markets;
> (4) promote the establishment of railroad rate structures which are more sensitive to changes in the level of seasonal, regional, and shipper demand;
> (5) promote separate pricing of distinct rail and rail-related services;
> (6) formulate standards and guidelines for determining adequate revenue levels for railroads; and
> (7) modernize and clarify the functions of railroad rate bureaus.[54]

A major purpose of the 4-R Act was to reform the ratemaking system to promote inter-railroad and intermodal competition. It allowed carriers to adjust rates up and down, subject to certain limitations. Carriers could lower rates below their full costs as long as their rates covered their variable costs (were not predatory). However, railroads could also raise rates in areas where they did not have market-dominant positions. The ICC established regulations regarding the test for market dominance.

> [A]ny one of three situations create[d] a rebuttable presumption that there [was] market dominance: "(1)

[52] Peter M. Mazer, *Assuring Adequate Rail Service: The Conflict Between Private Rights and Public Needs*, 45 Fordham L. Rev. 1429, 1440-1441 (1976-1977).

[53] Railroad Revitalization and Regulatory Reform Act of 1976, Pub. L. No. 94-210, 90 Stat. 31, 33 (1976).

[54] Railroad Revitalization and Regulatory Reform Act of 1976, Pub. L. No. 94-210, 90 Stat. 31, 33 (1976). Most of the information in this appendix regarding the 4-R Act comes from Forrest N. Krutter, *The Railroad Revitalization and Regulatory Reform Act of 1976: Improving the Railroads' Competitive Position*, 14 Harv. J. on Legis. 575, (1976-1977).

> Where the proponent carrier has handled 70 percent or more of the involved traffic or movement during the preceding year…; (2) Where the rate in issue exceeds the variable cost of providing the service by 60 percent or more; (3) Where affected shippers or consignees have made a substantial investment in rail-related equipment or facilities which prevents or makes impractical the use of another carrier or mode."[55]

Nevertheless, rail carriers could raise rates where they had market dominance if they could show that the rates were just and reasonable.

> [T]he burden of proof is on the common carrier by railroad to show that the proposed changed rate, fare, charge, classification, rule, regulation, or practice is just and reasonable. The Commission shall specifically consider, in any such hearing, proof that such proposed changed rate, fare, charge, classification, rule regulation, or practice will have a significantly adverse effect…on the competitive posture of shippers or consignees affected thereby.[56]

The ICC was also authorized to exempt traffic from rate regulation if it determined that it served no useful public purpose.

Under the provisions of the 4-R Act, railroads could adjust rates on a specific service within an experimental "rate free zone" (i.e., plus or minus seven percent) for a two-year period without ICC challenge except for rates challenged as discriminatory or predatory. Additionally, the 4-R Act limited the ICC's power to suspend rates outside the "rate free zone." If a railroad was planning a major capital expenditure, it could submit a rate that would, without ICC action within six months of submission, become effective and unchallengeable for five years.[57] Railroads could set peak load prices (prices that are higher at times of peak demand) and could also set rates for other services.

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[55] Forrest N. Krutter, *The Railroad Revitalization and Regulatory Reform Act of 1976: Improving the Railroads' Competitive Position*, 14 Harv. J. on Legis. 575, 599 (1976-1977), citing 41 Fed. Reg. 44,183 (1976) (codified in 49 C.F.R. §§ 1109.1 (g)(1)-(3)).

[56] Railroad Revitalization and Regulatory Reform Act of 1976, Pub. L. No. 94-210, 90 Stat 31, 38 (1976).

[57] There was an exception to this policy when the submitted rates would decrease the value of the carrier's going concern. If this was the case, the ICC could set a minimum rate equal to variable cost. Railroad Revitalization and Regulatory Reform Act of 1976, Pub. L. No. 94-210, 90 Stat 31, 42 (1976).

Additional restrictions were imposed on rate bureaus in an effort to prevent any restraint of trade arising from the new pricing flexibility. For example, only those carriers providing service on a particular through route could participate in the determination of the joint rate for that route.

Another element of the 4-R Act features an expanded role for the Secretary of Transportation. The Secretary is empowered to study and suggest mergers in order to strengthen rail carriers, and to mediate disputes arising in merger negotiations. In an expedited merger process (encompassing a two and a half year period), the Secretary of Transportation can investigate the proposed merger within the first six months, followed by Commission consideration within a two-year period. If the merger is proposed directly to the ICC, then it has a two and a half year period for consideration. The 4-R Act also created an Office of Rail Services Planning and made the Office of Rail Public Council within the ICC permanent and independent.[58]

The 4-R Act required the ICC to develop a uniform cost and revenue accounting for rail carriers and established the Railroad Rehabilitation and Improvement Fund to lend money to rail systems. The act also provides for shippers or localities to prevent abandonment of lines by purchasing or subsidizing the line.

The potential changes from the 4-R Act were, however, tempered by the ICC's implementation of the test for market dominance.

> Initially, private carriage and potential geographic or product competition were not considered in applying the 70-percent market-share presumption, even though these are all recognized parts of economic life. In 1979, the ICC, citing a 'misunderstanding,' agreed to do so. The 60 percent-over-variable-cost presumption was used as a rate ceiling to 'impede railroad pricing even more than was the case prior to the 4-R Act,' argued [Association of American Railroads' President] Mr. Dempsey.[59]

Just some four years after the 4-R Act became law, Congress passed the Staggers Rail Act of 1980. The stated purpose of the Staggers Act was to "provide for the restoration, maintenance, and improvement of the physical facilities and financial stability of the rail system of the United States."[60] An underlying policy of the Staggers Act was "to promote a safe and efficient rail

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[58] The Office of Rail Public Council represents communities and shippers in proceedings before the ICC. Railroad Revitalization and Regulatory Reform Act of 1976, Pub. L. No. 94-210, 90 Stat 31, 51, 57 (1976).

[59] Frank Wilner, *Railroads and the Marketplace*, 16 Transp. L.J. 291, 304 (1987-1988) citing Senate Transportation subcommittee, February 7, 1979.

[60] Staggers Rail Act of 1980, Pub. L. No. 96-448 § 3, 94 Stat. 1895, 1897 (1980).

transportation system by allowing rail carriers to earn adequate revenues, as determined by the Interstate Commerce Commission."[61] In 1980, Congress found that the "enactment of the Interstate Commerce Act [in 1887] was essential to prevent an abuse of monopoly power by railroads and to establish and maintain a national railroad network," however, "today, most transportation within the United States is competitive [and] earnings by the railroad industry are the lowest of any transportation mode and are insufficient to generate funds for necessary capital improvements."[62] Congress had established the ICC in order to ensure competition and protect rail customers without access to alternative shipping modes from abusive railroad rates and practices,[63] but the transportation industry had changed substantially since 1887 and access to alternative transportation modes was now readily available. In the last few decades of the 20th Century, the railroads were in a state of financial decline.

> The Staggers Act had nine fundamental regulatory changes:
>
> 1) Demand and competition were to be the principal regulators; regulation of maximum rates was to continue only where an absence of effective competition exists. [49 U.S.C. 10709 (1978)]
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> 2) Where the Interstate Commerce Commission retains jurisdiction of rail rates, it must take into consideration the revenue adequacy of a railroad in determining whether or not a rate is 'reasonable.' [49 U.S.C. 10701a (b) (3) and 10704 (a) (2) (1978)] (Although the Commission has emphasized that absence of revenue adequacy will not, in itself, guarantee approval of a rate.)
>
> 3) A rail cost recovery index—to measure the impact of inflation on railroad—was mandated. It permits quarterly rate changes to offset the increased costs of labor, materials and supplies, and is called the Rail Cost Adjustment Factor (RCAF). [49 U.S.C. 10712 (1978)]
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> 4) The ICC was to relinquish jurisdiction over minimum rates that contribute to going-concern value. [49 U.S.C. 10701a (c) (1) and (2) (1978)]

[61] Staggers Rail Act of 1980, Pub. L. No. 96-448 § 101 (a), 94 Stat. 1895, 1897 (1980).

[62] Staggers Rail Act of 1980, Pub. L. No. 96-448 § 2, 94 Stat. 1895, 1896 (1980).

[63] Robert Szabo, Executive Director and Counsel, CURE, "An Examination of S. 772, the Railroad Antitrust Enforcement Act," Oct. 3, 2007, pp. 1-2.

> 5) Competing routes and services could be priced differently, to reflect the demand for each. [49 U.S.C. 10741 (e), (f) (3) and (f) (4) (1978)]
>
> 6) Like every other business, railroads were permitted to enter into confidential contracts with their customers—contracts which, among other factors, could cover a guaranteed volume of freight for a specified time and with a guaranteed level of service. [49 U.S.C. 10713 (1978)]
>
> 7) Collective ratemaking was effectively abolished. Railroads can no longer collectively discuss single-line rates, and discussion on joint-line rates was limited to railroads that directly connect. [49 U.S.C. 10706 (a) (3) (A) (1978)]
>
> 8) The power of the Commission to authorize exemptions from the regulation was expanded to all cases where regulation was not necessary to carry out the National Transportation Policy and the matter exempted was of limited scope, or regulation was not needed to protect shippers from an abuse of market power. [49 U.S.C. 10505 (1978)]
>
> 9) States were required to conform their standards for intrastate rail regulation to those used by the ICC. [49 U.S.C. 11501 (1978)].[64]

Notably, the Staggers Act allowed rail carriers to establish rates without ICC interference unless the carrier had market dominance—in which case the carrier's rate must be determined to be "reasonable" by the ICC. Congress specified a safe harbor test for market dominance—if the revenue-to-variable-cost percentage is below a certain percentage, as specified in the Act, then the rail carrier could not be found to have market dominance.[65] The Staggers Act also granted additional freedom to rail carriers in setting rates for joint routes or canceling them, although the ICC could suspend route cancellations or prescribe through routes when in "the public interest." Additionally, the Staggers Act codified the ability of shippers and carriers to enter into private contracts without substantial ICC oversight.

The ICC's role and responsibilities were substantially diminished by the Staggers Act. Within a few years of the Staggers Act's passage, President Reagan's budget director proposed abolishing the Interstate Commerce Commission and even went so far as to provide no funding for the ICC in the Reagan administration's proposed budget for fiscal year 1987. Over the 15 year period following the passage of the Staggers Act, the ICC was

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[64] Frank Wilner, *Railroads and the Marketplace*, 16 Transp. L.J. 291, 308 (1987-1988).

[65] Staggers Rail Act of 1980, Pub. L. No. 96-448 § 202, 94 Stat. 1895, 1900 (1980).

significantly downsized. Finally, the Interstate Commerce Commission Termination Act of 1995 dissolved the Interstate Commerce Commission and vested the ICC's remaining responsibilities with a newly created Surface Transportation Board. The Interstate Commerce Commission Termination Act of 1995 declared it U.S. policy:

> (1) to allow, to the maximum extent possible, competition and the demand for services to establish reasonable rates for transportation by rail;
>
> (2) to minimize the need for Federal regulatory control over the rail transportation system and to require fair and expeditious regulatory decisions when regulation is required;
>
> (3) to promote a safe and efficient rail transportation system by allowing rail carriers to earn adequate revenues, as determined by the Board;
>
> (4) to ensure the development and continuation of a sound rail transportation system with effective competition among rail carriers and with other modes, to meet the needs of the public and the national defense;
>
> (5) to foster sound economic conditions in transportation and to ensure effective competition and coordination between rail carriers and other modes;
>
> (6) to maintain reasonable rates where there is an absence of effective competition and where rail rates provide revenues which exceed the amount necessary to maintain the rail system and to attract capital;
>
> (7) to reduce regulatory barriers to entry into and exit from the industry;
>
> (8) to operate transportation facilities and equipment without detriment to the public health and safety;
>
> (9) to encourage honest and efficient management of railroads;
>
> (10) to require rail carriers, to the maximum extent practicable, to rely on individual rate increases, and to limit the use of increases of general applicability;
>
> (11) to encourage fair wages and safe and suitable working conditions in the railroad industry;
>
> (12) to prohibit predatory pricing and practices, to avoid undue concentrations of market power, and to prohibit unlawful discrimination;
>
> (13) to ensure the availability of accurate cost information in regulatory proceedings, while minimizing the burden on rail

> carriers of developing and maintaining the capability of providing such information;
>
> (14) to encourage and promote energy conservation; and
>
> (15) to provide for the expeditious handling and resolution of all proceedings required or permitted to be brought under this part.[66]

SECTION B. CURRENT STB OVERSIGHT OF RAILROAD INDUSTRY

Organization of the Relevant Portion of the United States Code

Title 49 of the United States Code governs transportation and is divided into ten subtitles. The statutes governing the authorization and administration of the STB are found in Chapter 7 of the first subtitle, Department of Transportation. Subtitle IV of Title 49 deals specifically with interstate transportation, and the Interstate Commerce Act, as amended, is currently codified within this subtitle. Subtitle IV is subdivided into three parts.[67] Part A is entitled "Rail" and contains nine chapters,[68] divided into sections §§ 10101-11908, which apply to the railroad industry.[69] These sections are the codification of the Interstate Commerce Act, as amended, that governs the railroads and are administered exclusively by the STB.

Jurisdiction

The jurisdiction of the STB is established under Chapter 105. The STB has exclusive jurisdiction in the United States over:

> (1) transportation by rail carriers, and the remedies provided in this part with respect to rates, classifications, rules (including car service, interchange, and other operating rules), practices, routes, services, and facilities of such carriers; and (2) the construction, acquisition, operation, abandonment or discontinuance of spur, industrial, team, switching, or side tracks, or facilities,

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[66] ICC Termination Act of 1995, Pub. L. No. 104–88, 109 Stat. 803, 805-806 (1995) (codified at 49 U.S.C. § 10101).

[67] Part A covers rail: Part B covers motor carriers, water carriers, brokers, and freight forwarders: and Part C covers pipeline carriers.

[68] The nine chapters included in Part A are Chapters 101, 105, 107, 109, 111, 113, 115, 117, and 119.

[69] In the statutes quoted and discussed below, references to "part" refer to the entire Part A covering the railroad industry, including all sections § 10101 through § 11908.

> even if the tracks are located, or intended to be located, entirely in one State,…[70]

In performing its oversight duties, the STB has the authority to make inquiries into and report upon the business of carriers as well as request information from carriers.[71] The STB can subpoena witnesses and take witness depositions in proceedings.[72] A Board action remains in effect until it expires, is suspended, or is superseded.[73] The STB can, on its own initiative or upon request, reopen and reconsider a previous action, or, on its own initiative, it can reopen a proceeding.[74]

Exemptions

The STB has a mandate to exempt rail carrier transportation from the application of the statute "to the maximum extent consistent" with the statute when its application is not necessary to carry out the rail transportation policy, and the transaction is either limited in scope or the application of the statute is not needed to stay the abuse of market power.[75] The exemption can apply to "a person, class of persons, or a transaction or service."[76] The STB may limit the duration of the exemption or revoke the exemption to meet the U.S. rail transportation policy.[77] The STB may not exempt a rail carrier from obligations to provide contractual terms for liability and claims under 49 U.S.C. § 11706 or to protect the interests of its employees.[78] The STB has established procedures for petitions to exempt a transaction or service, or to revoke an existing exemption.[79]

Under this provision, there are currently a number of active, specified exemptions.[80] Agricultural products (except grain, soybeans, and sunflower

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[70] 49 U.S.C. § 10501 (b).

[71] 49 U.S.C. § 721 (b).

[72] 49 U.S.C. § 721 (c) and (d).

[73] 49 U.S.C. § 722 (b).

[74] 49 U.S.C. § 722 (c).

[75] 49 U.S.C. § 10502 (a) [emphasis added].

[76] 49 U.S.C. § 10502 (a).

[77] 49 U.S.C. § 10502 (c) and (d).

[78] 49 U.S.C. §§ 10502 (e) and (g), respectively.

[79] 49 C.F.R. pt. 1121.

[80] 49 C.F.R. pt. 1039. The application of three exemptions (49 C.F.R. § 1039.12 exemption regarding long and short haul transportation from the requirements under 49 U.S.C. § 10726; 49 C.F.R. § 1039.17 exempting protective service contracts from the requirements of 49 U.S.C. § 11105; and 49 C.F.R. § 1039.22 exempting certain market development activities from the anti-rebating requirements of 49 U.S.C. §§ 10761 (a), 10762 (a)(1), 11902, 11903, 11904 (a)),were effectively eliminated by the ICC Termination Act of 1995 where these sections of the U.S. Code were repealed.

seeds) are exempt, however "carriers must continue to comply with [STB] accounting and reporting requirements,… and must maintain copies of rates, charges, rules or regulations, for traffic moved under [the] exemption."[81] In addition to agricultural products, there are other miscellaneous categories of commodities that have also been exempted under §10502, except for "any movement for which a finding of market dominance has been made."[82] With regard to these miscellaneous commodities, this exemption does not affect

[81] 49 C.F.R. § 1039.10. The categories of commodities which are exempt under this STB decision are (by standard transportation commodity code): Farm products (except grain, soybeans, and sunflower seeds); fresh fish and other marine products; fresh meat; fresh dressed poultry; processed poultry; creamery butter; condensed, evaporated or dried milk; cheese and special dairy products; processed whole milk; hides and skins; animal refuse, tankage, or meat meal; citrus pomace; shelled walnuts; cottonseed hulls; cotton linters; butter and honey mixed; honey, comb, granulated or strained, or heat treated to retard granulation; freeze-dried poultry; freeze-dried meat; freeze-dried salad ingredients; fresh and salted meat and products mixed, not hung; fresh and salted meat and products mixed, hung and not hung; stemmed or redried tobacco; cotton, carded, dyed or not dyed, but not spun, woven or knitted, but including cotton lap; mattress felt, nec, cjors, not finished; felts, cotton, nec; wool, nec, scoured; flax fibre; cotton linters, bleached or dyed; and beeswax.

[82] 49 C.F.R. § 1039.11. The categories of commodities which are exempt under this STB decision are (by standard transportation commodity code): dimension stone, quarry; crushed or broken stone or riprap; sand; gravel; certain food or kindred products; textile mill products; apparel or other finished textile products or knit apparel; lumber or wood products; furniture or fixtures; certain pulp, paper or allied products; printed matter; iron chloride, liquid; iron sulphate; ferrous sulphate; coke produced from coal; distillate or residual fuel oil from coal refining; certain rubber or miscellaneous plastics products; leather or leather products; certain clay, concrete, glass or stone products; primary metal products, including galvanized; certain fabricated metal products; certain machinery; certain electrical machinery, equipment or supplies; motor vehicles; motor vehicles parts or accessories; instruments, photographic goods, optical goods, watches or clocks; miscellaneous products of manufacturing; used vehicles; rock salt; grease or inedible tallow; carbon dioxide; salt; hydraulic cement; steel shipping containers; iron and steel scrap; blast furnace, open hearth, rolling mill or coke oven products, nec; certain bread or bakery products; textile waste, garnetted, processed, or recovered or recovered fibres or flock excluding packing or wiping cloths or rags; textile fibres, laps, noils, nubs, roving, sliver or slubs, prepared for spinning, combed or converted; packing or wiping clothes or rags; shavings or sawdust; reclaimed rubber; cullet (broken glass); copper matte, speiss, flue dust, or residues, etc.; lead matte, speiss, flue dust, dross, slag, skimmings, etc.; zinc dross, residues, ashes, etc.; aluminum residues, etc.; miscellaneous nonferrous metal residues, including solder babbitt or type metal residues; ashes; brass, bronze, copper or alloy scrap, tailings, or wastes; lead, zinc, or alloy scrap, tailings, or wastes; tin scrap, consisting of scraps or pieces of metallic tin, clippings, drippings, shavings, turnings, or old worn-out block tin pipe having value for remelting purposes only; textile waste, scrap or sweepings; wood scrap or waste; paper waste or scrap; chemical or petroleum waste, including spent; rubber or plastic scrap or waste; municipal garbage waste, solid, digested and ground, other than sewage waste or fertilizer; automobile shredder residue; bags, old, burlap, gunny, istle (ixtle), jute, or sisal, nec; articles, used, returned for repair or reconditioning; nonrevenue movement of containers, bags, barrels, bottles, boxes, crates, cores, drums, kegs, reels, tubes, or carriers, nec, empty, returning in reverse of route used in loaded movement, and so certified; nonrevenue movement of shipping devices, consisting of blocking, bolsters, cradles, pallets, racks, skids, etc., empty, returning in reverse of route used in loaded movement, and so certified; revenue movement of containers, bags, barrels, bottles, boxes, crates, cores, drums, kegs, reels, tubes, or carriers, nec., empty, returning in reverse of route used in loaded movement and so certified.

existing regulations regarding the use of equipment and exemptions from the antitrust laws necessary to negotiate car service regulations or equipment interchange. In addition, the exemption does not relieve carriers of their obligations to comply with accounting and reporting requirements. The STB has also issued an exemption for rail intermodal transportation.[83] "Rail [trailer-on-flatcar/container-on-flatcar (TOFC/COFC)] service and highway TOFC/COFC service provided by a rail carrier either itself or jointly with a motor carrier as part of a continuous intermodal freight movement is exempt from the requirements of 49 U.S.C. subtitle IV [Interstate Transportation §§ 10101-16106],…."[84] Rail transportation of new highway trailers or containers (not otherwise exempt) is exempt except for accounting and reporting requirements.[85] There is also an exception for rail transportation in boxcars.[86] With certain exceptions, all commodities transported by rail in boxcars are exempt from the provisions of 49 U.S.C. subtitle IV. The exceptions where the STB maintains its jurisdiction are "(1) car hire and car service, (2) mandatory interchange of equipment, (3) reciprocal switching or joint use of terminal facilities, (4) car supply, [and] (5) freight car pooling agreements."[87] The STB also retains jurisdiction as to certain aspects of freight rates on boxcar traffic to or from an industry facility served physically by a Class III carrier—specifically with regard to legislated restrictions on joint rates and through routes codified at 49 U.S.C. § 10705, and STB mandates on non-discriminatory rates on the basis of boxcar ownership or reporting marks, the boxcar car hire rate, or any car hire discounts available to any carriers.[88] Regardless of the boxcar exemption, carriers must continue to comply with the accounting and reporting requirements. There is an exemption for the leasing of railroad equipment for non-transporting storage purposes.[89] This exemption does not apply in cases of car shortage or emergencies arising under 49 U.S.C. § 11123.

STB Oversight

Certain STB rail oversight functions are discussed under the following topics: common carrier obligations and private contracts; rates; rail

[83] 49 C.F.R. § 1039.13 and pt. 1090.

[84] 49 C.F.R. § 1090.2. This exemption was discussed on a petition for partial revocation of the exemption in *WTL Rail Corporation Petition for Declaratory Order and Interim Relief*, STB Ex Parte No. 230 (Sub-No. 9), STB Docket No. 42092 (STB served February 17, 2006). The petition was denied.

[85] 49 C.F.R. § 1039.16.

[86] 49 C.F.R. § 1039.14.

[87] 49 C.F.R. § 1039.14 (b).

[88] 49 C.F.R. §§ 1039.14 (b)(6), (c)(4), and (c)(5).

[89] 49 C.F.R. § 1039.20.

construction, operation, and acquisitions; railroad abandonment; and the interchange of traffic.[90]

Common Carrier Obligations and Private Contracts[91]

All railroads subject to STB jurisdiction have a common carrier obligation to "provide the transportation or service on reasonable request."[92] A shipper and a railroad are also authorized to enter into private contract for transportation.[93] Before fulfilling common carrier obligations, railroads can first fulfill reasonable contract commitments.[94] However, if the contract commitments prevent the railroad from fulfilling its common carrier obligations they are by definition not "reasonable."[95]

Common Carrier Obligations

As part of their common carrier obligations, railroads have to provide written rate and service terms upon request (including the establishment of a new rate) and provide a 20-day notice before changing these terms.[96] The rail carrier's obligation is to provide transportation in accordance with these rates and terms.[97] With regard to agricultural (and fertilizer) products, in addition to the requirements noted above, common carrier rates, schedules of rates, and

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[90] There are a number of categories of STB oversight that are not discussed herein, including Car Service [49 U.S.C. §§ 11121-11124], Reports and Records [49 U.S.C. §§ 11141-11145], Railroad Cost Accounting [49 U.S.C. §§ 11161-11164], Federal-State Relations [49 U.S.C., Chapter 115], and Civil and Criminal Penalties [49 U.S.C., Chapter 119].

[91] 49 U.S.C. § 11101 is entitled "Common carrier transportation, service, and rates." 49 U.S.C. § 10709 is entitled "Contracts."

[92] 49 U.S.C. § 11101 (a). "The exemption of a commodity under 49 U.S.C. 10502 generally excuses carriers from virtually all aspects of regulation involving the transportation of that commodity. This includes the dual requirements that carriers furnish rates and provide service on reasonable request pursuant to those rates. Thus, even if a carrier's conduct would constitute a statutory violation during a period of regulation, the exemption bars regulatory relief during the period when the exemption is in force." *Pejepscot Industrial Park, Inc., d/b/a/ Grimmel Industries—Petition for Declaratory Order,* STB Finance Docket No. 33989, (STB Served May 15, 2003), p. 6; citing *Consolidated Rail Corp.– Declaratory Order – Exemption*, 1 I.C.C.2d 895 (1986) (Conrail Declaratory Order), *aff'd sub nom. G&T Terminal Packaging Co., Inc. v. Consolidated Rail Corp.,* 830 F.2d 1230, 1235 (3d Cir. 1987).

[93] 49 U.S.C. § 10709 (a).

[94] 49 U.S.C. § 11101 (a). Private contracts for carriage (discussed below) are permissible under 49 U.S.C. § 10709 and are not subject to STB jurisdiction.

[95] 49 U.S.C. § 11101 (a).

[96] 49 U.S.C. §§ 11101 (b) and (c). The 20-day notice requirement applies to any person who has requested written rate and service terms (including a request for notification of future increases per 49 C.F.R. § 1300.2) or has made arrangements for a shipment that would be affected by the change within the previous 12 months. The rate notice requirements do not apply to services exempted by the STB under 49 U.S.C. § 10502. See 49 C.F.R. § 1300.1 (d).

[97] 49 U.S.C. § 11101 (e).

service terms as well as any scheduled changes thereto must be published, made available, and retained for public inspection by the railroad.[98] The published information "must be arranged in a way that allows for the determination of the exact rate, charges, and service terms applicable to any given shipment (or to any given group of shipments)."[99] Changes must be emphasized in a way that makes them easily identifiable.[100]

One of the STB's roles with regard to the common carrier obligations is to promulgate rules to implement the common carrier obligations, providing for the immediate disclosure and distribution of rates and service information.[101] The rules adopted by the STB pursuant to 49 U.S.C. § 11101 regarding the disclosure, publication, and notification regarding change of rates and service terms are published in the Code of Federal Regulations at 49 C.F.R. pt. 1300.[102] The STB's rules indicate that the disclosure requirements of 49 U.S.C. §§ 11101(b), (c), (d), and (f) do not apply to contracts (allowed under 49 U.S.C. § 10709) or to any of the carriage or services to the extent they are exempted by the STB under its mandate (49 U.S.C. § 10502), discussed above. If, upon a complaint, the STB finds that a rail carrier is in violation of the statutes, the STB can compel its compliance.[103]

The STB held a hearing on April 24 and 25, 2008, in Washington, D.C., to examine issues related to the common carrier obligation of railroads. The topics covered included:

> (1) service limitation resulting from a capacity constrained environment; (2) cost and safety issues related to the transportation of hazardous materials, especially toxic inhalation hazards; (3) carrier-imposed requirements for infrastructure investments by shippers; (4) the impact of volume requirements or incentives; (5) economically motivated service reductions and metering of the demand for service; (6) the proper use of rail embargoes; (7) when it becomes necessary to obtain abandonment

[98] 49 U.S.C. § 11101 (d).

[99] 49 C.F.R. § 1300.5 (b).

[100] 49 C.F.R. § 1300.5 (b).

[101] 49 U.S.C. § 11101 (f).

[102] In addition, 49 C.F.R. pts. 1146 and 1147 provide rules for seeking relief and emergency services in cases where inadequate service has been provided, pursuant to the requirements under 49 U.S.C. § 11101.

[103] 49 U.S.C. § 11701 (a).

> authorization; and (8) to whom does the common carrier obligation apply.[104]

Many issues related to the obligation of railroads to haul hazardous materials were raised at the hearing. Discussions indicated that, for many hazardous materials including toxic by inhalation hazards (TIH), rail is the safest and most efficient mode of transportation. However, according to the railroads, the transportation of these materials subjects them to ruinous liability in the event of an accident.

To allow for more detailed discussion of issues raised at its April 24, 2008 hearing, the STB held another hearing on July 22, 2008 (originally scheduled for July 16, 2008) in Washington, D.C., to examine issues related to the common carrier obligation of railroads with respect to the transportation of hazardous materials. The Board was interested in specific potential policy solutions to liability issues of railroads hauling hazardous materials, including solutions modeled on the Price-Anderson Act of 1957. In addition, there were discussions about whether there are unique costs associated with the transportation of hazardous materials and how railroads can recover these costs. Parties were also invited to comment on what constitutes a reasonable request for service involving the movement of TIH. To date, the STB has not issued any decisions regarding either the April 24-25, 2008 or the July 22, 2008 hearings.

Private Contracts

As discussed above, shippers and rail carriers are allowed by statute to enter into private contracts. The terms of the contract are confidential and govern the relationship between the parties. Judicial, not agency, relief is available for complaints regarding the interpretation or violation of private contracts.

Despite the confidentiality of private contracts, rail carriers must file a summary of non-confidential terms for each agricultural contract (or amendment thereto) within seven days of execution with the STB—except for exempted transactions under 49 U.S.C. § 10502.[105]

For summaries of agricultural product contracts filed with the STB under 49 U.S.C. § 10709(d), the STB can review these contracts upon a complaint by a shipper or a port filed within 18 days of the contract summary

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[104] *Common Carrier Obligation of Railroads*, STB Ex Parte No. 677 (STB served February 22, 2008) (STB notice of public hearing), p. 2. For a complete list of all proceedings regarding STB Ex Parte No. 677, see http://www.stb.dot.gov/FILINGS/all.nsf/(Personal-216.170.165.28)?OpenView&Count=300.

[105] 49 U.S.C. § 10709 (d). STB rules governing the implementation of this requirement are found at 49 C.F.R. pt. 1313. Non-confidential terms must be filed within seven days under 49 C.F.R. § 1313.4 (a). Transactions exempted by the STB under 49 U.S.C. § 10502 are not subject to these requirements per 49 C.F.R. § 1313.1 (b).

filing.[106] Any shipper can lodge a complaint with the STB on the basis that the contract will injure the shipper because the contract will "unduly impair" the carrier's ability to fulfill its common carrier obligations.[107] In addition, an agricultural commodity shipper can file a complaint if the carrier has contemporaneously "unreasonably discriminated" against the shipper by refusing to contract with the shipper under similar terms and conditions, or the proposed contract "constitutes a destructive competitive practice."[108] A port can file a complaint if the contract will result in unreasonable discrimination against the port.[109] If the STB finds a violation, it will disapprove the contract and the appropriate non-contract rates/charges will apply.[110] For discrimination complaints filed by an agricultural shipper, the STB can order the carrier to provide services to the shipper on substantially similar terms as those in the disputed contract.

Rates

The chapter of the U.S. Code governing rail rates is divided into three subchapters. The first subchapter, entitled General Authority, provides the authority and sets the standards for rates, classifications, routes, rules, and practices. The second subchapter addresses two special circumstances: government traffic and car utilization. The third subchapter covers limitations on rates. [111]

Authorizations

A rail carrier is authorized to establish any rate for transportation or other service provided by the rail carrier except where the STB has determined that a rail carrier has market dominance or where "a rate is prohibited by a provision of this part."[112] A rail carrier is authorized to "establish reasonable—(1) rates, to the extent required by section 10707 [determination of market dominance], divisions of joint rates, and classifications for transportation and service it may provide under this part; and (2) rules and practices on matters related to that transportation or service."[113] Where the rail carrier has market dominance as determined by the STB, its rates must be reasonable.[114] If the

[106] 49 C.F.R. § 1313.10 (a). As discussed above, this does not apply to agricultural products exempted under 49 U.S.C. § 10502 per 49 CFR § 1313.1 (b).

[107] 49 U.S.C. § 10709 (g)(2)(A)(i).

[108] 49 U.S.C. § 10709 (g)(2)(B).

[109] 49 U.S.C. § 10709 (g)(2)(A)(ii).

[110] 49 C.F.R. §§ 1313.3 (b)(1) and (c).

[111] 49 U.S.C. ch. 107.

[112] 49 U.S.C. § 10701 (c).

[113] 49 U.S.C. § 10702.

[114] 49 U.S.C. § 10701 (d)(1).

STB determines that the rail carrier does not have market dominance, then that finding is determinative for that rate unless changed or set aside by the Board or a court.[115]

Rail carriers are also authorized to establish through routes with each other and water carriers, and to establish rules, provide facilities, and reasonable compensation for their operation.[116] Through routes and the division of joint rates must be reasonable, and joint rates must be divided without unreasonable discrimination against a participating carrier.[117] One carrier may not discriminate in its rates or in the distribution of traffic against a connecting line of another rail carrier.[118] The STB is also authorized to prescribe through routes, joint classifications, joint rates (and the division thereof), and operational conditions "when it considers it desirable in the public interest."[119] The STB can prescribe the division of joint rates when it decides the division established by the participating carriers is unreasonable or discriminatory.[120] The STB also has the authority to make a retroactive adjustment where it has prescribed a division of a joint rate that is later found to violate § 10701.[121]

Certain limited rate agreements among rail carriers are permissible with approval by the Board and are exempted from the application of antitrust laws.[122] The STB's approval is limited to cases where the agreement will further the rail transportation policy specified by Congress. Under the U.S. Code, an organization established under a Board-approved agreement may not allow carriers to discuss or participate in agreements related to single line rates of another carrier (except in cases such as general purpose rate increases, or broad changes in rates and practices), or interline traffic (except where the

[115] 49 U.S.C. § 10707 (b).

[116] 49 U.S.C. § 10703.

[117] 49 U.S.C. § 10701 (a). A joint rate is a unitary rate set by mutual agreement between participating carriers that is applied to the entire through movement. In contrast, a proportional rate is set by a single carrier for applicability to only its portion of a through movement. A proportional rate is different from a local rate. A local rate is a rate for transportation originating and terminating on the carrier's line, while a proportional rate is expressly conditioned to apply only to traffic having a prior or subsequent movement on another carrier's line through a specified exchange point. *Central Power & Light Co. v. Southern Pacific Transportation Co., et al.*, STB Docket No. 41242 et al., Decision (STB served December 27, 1996), p.2 note 3.

[118] 49 U.S.C. § 10701 (b).

[119] 49 U.S.C. § 10705 (a)(1).

[120] 49 U.S.C. § 10705 (b).

[121] 49 U.S.C. § 10705 (c).

[122] 49 U.S.C. § 10706.

carrier is a participant).[123] Certain limited agreements related to carrier compensation for the use of rolling stock may also be permitted with STB approval if the STB determines that the agreements will further the transportation policy.

Complaints

A rate can be challenged as being unreasonable pursuant to a complaint.[124] The Board determines whether the carrier proposing the rate has market dominance over the transportation to which the challenged rate applies.[125] Market dominance is defined as "an absence of effective competition from other rail carriers or modes of transportation for the transportation to which a rate applies."[126] In cases where the STB finds that a rail carrier has market dominance, it may then determine the challenged rate to be unreasonable if it exceeds a reasonable maximum. "However, a finding of market dominance does not establish a presumption that the proposed rate exceeds a reasonable maximum."[127]

Determining Market Dominance

Establishing the existence of market dominance is a prerequisite to the STB's jurisdiction to review the reasonableness of a challenged rate.[128] The legislature has specified a "safe harbor" test for proving a lack of market dominance. The determination is made that a rail carrier does not have market

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[123] 49 U.S.C. § 10706 (a)(3). Mr. Charles Nottingham, Chairman of the STB, testified before the Senate Committee on the Judiciary regarding Senate Bill 772 (the Railroad Antitrust Enforcement Act) on October 3, 2007. Mr. Nottingham testified that the application of § 10706 is limited. "In practice, there are very few section 10706 agreements in place today. In 1998, the Board approved certain rate-related aspects of the Rail Industry Agreement (RIA) between Class I carriers and short lines railroads. Another section 10706 agreement is the Association of American Railroads Code of Car Hire. Under the Code, the railroads collectively establish rules governing the charges that railroads pay each other when using the equipment (typically rail cars) of another railroad. The railroads do not, however, collectively establish the rates for car hire under the Code or any other section 10706 agreement. In 1996, the Board withdrew approval for carriers to collectively establish demurrage and storages rates. The ICC also approved the agreement of the National Railroad Freight Committee, which has in the past published the Uniform Freight Classification for its members." C. Nottingham, *An Examination of S. 772, the Railroad Antitrust Enforcement Act*, October 3, 2007, pp. 4-5.

[124] 49 U.S.C. § 10704 (b). The STB's procedural requirements for filing a complaint are found at 49 C.F.R. pt. 1111. The STB's procedures particular to filing a rate complaint are at 49 C.F.R. pts. 1130-1149.

[125] 49 U.S.C. § 10707 (b). Voluntary, binding arbitration is also available to parties for resolving disputes involving the payment of money, rates, or transportation services. See 49 C.F.R. pt. 1108. Matters that are subject to arbitration are specified at 49 C.F.R. § 1108.3.

[126] 49 U.S.C. § 10707 (a).

[127] 49 U.S.C. § 10707 (c).

[128] *Market Dominance Determinations*, STB Ex Parte No. 627, STB Reports, Volume 3, p. 937 (1998).

dominance over the transportation to which the challenged rate applies if the "rail carrier proves that the rate charged results in a revenue-variable cost percentage for such transportation that is less than 180 percent."[129] This comparison is referred to as the quantitative test for market dominance. For the purposes of this test, variable costs of the rail carrier "shall be determined only by using such carrier's unadjusted costs, calculated using the Uniform Rail Costing System [URCS] cost finding methodology…"[130]

Even if a rail carrier's revenue-variable cost percentage is greater than 180 percent, that does not establish a presumption that the carrier has market dominance or that the challenged rate exceeds a reasonable maximum.[131] In such a case, the STB considers whether transportation alternatives are available to the complaining shipper. This consideration is referred to as the qualitative test for market dominance.[132]

The STB currently considers two types of competition in its qualitative market dominance analysis: intramodal and intermodal competition (where the shipper can use rail or other transportation modes to transport the same commodity between the same two points.) Under the qualitative test, the complaining shipper must establish the absence of both types of effective competition.[133] The shipper can satisfy the qualitative test, even where there is some form of competition, by demonstrating that the competition is not an effective constraint on the challenged rate.[134] In a 1981 decision, the ICC enumerated various factors for determining the degree to which there is effective competition. Evidence related to establishing the degree of intramodal competition includes:

(1) the number of rail alternatives;
(2) the feasibility of each alternative as evidenced by:
  (a) physical characteristics of the route associated with each alternative that are indicative of the feasibility of using that alternative for the traffic in question (e.g. circuity, track conditions, et cetera); and

[129] 49 U.S.C. § 10707 (d)(1)(A).

[130] 49 U.S.C. § 10707 (d)(1)(B).

[131] 49 U.S.C. §§ 10707 (d)(2)(A) and (B).

[132] *E.I. Dupont de Nemours & Co. v. CSX Transportation, Inc.*, STB Docket No. 42101 (STB served June 30, 2008), p. 2.

[133] *E.I. Dupont de Nemours & Co. v. CSX Transportation , Inc.*, STB Docket No. 42101 (STB served June 30, 2008), p. 2; citing *CSX Corp. et al. – Control – Conrail Inc. et al.*, 3 S.T.B. 196 (1998); *Government of the Territory of Guam v. Sea-Land Serv., Inc.*, STB Docket No. WCC-101, slip op. at 6 (STB served Feb. 2, 2007).

[134] *E.I. Dupont de Nemours & Co. v. CSX Transportation , Inc.*, STB Docket No. 42101 (STB served June 30, 2008), p. 2; citing *Market Dominance Determinations*, 365 I.C.C. 118, 129 (1981).

(b) the direct access of both the shipper and the receiver to each of the rail alternatives as evidenced by individual rail sidings, neutral terminal companies or reciprocal switching; or, if direct access is not available, then the feasibility of using local trucking to transport the commodity to or from terminals;

(3) the transportation costs associated with each alternative (to determine if actual use of alternatives is due to excessive rates charged by the rail carrier in question);

(4) collective ratemaking among the railroads in question as evidenced by rate bureau involvement; and

(5) evidence of substantial rail-related investment or long-term supply contracts…[135]

The factors related to intermodal competition depend upon the type of transportation at issue. For water carriage, the evidence enumerated by the ICC related to establishing the degree of competition includes:

(1) the number of alternatives involving different carriers;

(2) the feasibility of each alternative as evidenced by

(a) pertinent physical characteristics, for each product in question, of the transportation or routing associated with each alternative;

(b) the access of both the shipper and the receiver to each alternative; and

(4)[*sic*] the transportation costs of each alternative.[136]

For motor carriage, the evidence includes:

(1) the amount of the product in question that is transported by motor carrier where rail alternatives are available;

(2) the amount of the product that is transported by motor carrier under transportation circumstances (e.g., shipment size and distance) similar to rail;

(3) the amount of the product that is transported using motor carrier by shippers with similar needs (distributional, inventory, et cetera) as the shipper protesting the rate;

(4) physical characteristics of the product in question that may preclude transportation by motor carrier; and

[135] *Market Dominance Determinations*, 365 I.C.C. 118, 132 (1981).

[136] *Market Dominance Determinations*, 365 I.C.C. 118, 133 (1981).

(5) the transportation costs of the rail and motor carrier alternatives.[137]

In 1998, the Board eliminated the consideration of two additional types of competition that had been a part of the test in determining a rail carrier's market dominance since 1981: product competition and geographic competition. Product competition is the case where "the complaining shipper can avoid using the defendant railroad by shipping or receiving a substitute product."[138] Geographic competition is the case where "the complaining shipper can avoid using the defendant railroad by obtaining the same product from a different source, or by shipping the same product to a different destination."[139] After taking comments on whether product and geographic competition should be eliminated as factors in determining market dominance, the STB concluded,

> As both the record here and many years of experience in the rail rate cases demonstrate, consideration of product and geographic competition significantly impedes the efficient processing of such cases. Accordingly, to comply with both the recent legislative directive to process rate complaints more expeditiously and the long-standing Congressional intent that market dominance be a practical determination made without delay, we will limit the evidence that can be considered to only that required by the statute, *i.e.*, competition 'for the transportation to which a rate applies.' We believe that the limited impact on the rail industry from this decision is far outweighed by the chilling effect that the inclusion of product and geographic competition can have on the filing of valid rate complaints by captive shippers and on the resolution of rate complaints in a timely manner. And we also believe that negating this chilling effect will further level the playing field between railroads and shippers to the extent that disputes will be resolved in the private sector.[140]

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[137] *Market Dominance Determinations*, 365 I.C.C. 118, 133 (1981).

[138] *Market Dominance Determinations,* STB Ex Parte No. 627, STB Reports, Volume 3, 1998, p. 937.

[139] *Market Dominance Determinations,* STB Ex Parte No. 627, STB Reports, Volume 3, 1998, p. 937.

[140] *Market Dominance Determinations,* STB Ex Parte No. 627, STB Reports, Volume 3, 1998, p. 938.

Before this change, the rail carrier had the burden to show that product or geographic competition served as an effective limit on its rates.[141] The discovery process to gather evidence on these matters was substantial and time-consuming, and did not fit the expedited schedule desired by the STB. In its decision to no longer consider evidence of product and geographic competition in market dominance determinations, the STB stated, "The record indicates that the prospect of protracted litigation on issues of product and geographic competition discourages captive shippers from seeking legitimate relief through the regulatory avenue that Congress has provided."[142] There was a petition to reconsider this ruling, but the Board denied that petition in a July 1999 decision. In upholding their initial decision, the STB stated,

> The very heavy burden on shippers from contending with product and geographic competition issues extends well beyond discovery. Contrary to [the petitioner's] contention, the record is replete with testimony from shippers that the burden of preparing evidentiary presentations in response to allegations of effective product and geographic competition is quite substantial. Product and geographic competition issues often involve non-transportation aspects of a shipper's business and, because the agency lacks extensive expertise in non-transportation industries, the burden on the shipper to fully educate the Board on its industry and its operations can be very great…
>
> The consideration of product and geographic competition also places a heavy burden on this agency.[143]

Determining Reasonableness

Background

If the STB makes a determination that a rail carrier has market dominance over a transportation service, then the applicable rate for that transportation service must be reasonable.[144] Where a carrier has market dominance, then in determining whether the rate is reasonable, the statute requires that the STB:

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[141] *Market Dominance Determinations,* STB Ex Parte No. 627, STB Reports, Volume 3, 1998, p. 941.

[142] *Market Dominance Determinations,* STB Ex Parte No. 627, STB Reports, Volume 3, 1998, p. 943.

[143] *Market Dominance Determinations—Product and Geographic Competition,* STB Ex Parte No. 627, Docket No. 42022, (STB served July 2, 1999), p. 8.

[144] 49 U.S.C. § 10701 (d)(1).

> …shall give due consideration to—
> (A) the amount of traffic which is transported at revenues which do not contribute to going concern value and the efforts made to minimize such traffic;
> (B) the amount of traffic which contributes only marginally to fixed costs and the extent to which, if any, rates on such traffic can be changed to maximize the revenues from such traffic; and
> (C) the carrier's mix of rail traffic to determine whether one commodity is paying an unreasonable share of the carrier's overall revenues, …[145]

This determination of the reasonableness of the rate is to be made "recognizing the policy of this part that rail carriers shall earn adequate revenues, as established by the Board under section 10704(a)(2) of this title."[146]

> When there is a challenge to the reasonableness of a rail rate charged for captive traffic, [the STB's] regulatory task is to determine whether the degree of differential pricing--i.e., the amount by which the revenues derived from the traffic at issue exceed the long-run marginal cost (LRMC) of handling the traffic--is reasonable.[147]

Until 1996, rates were challenged as unreasonable under a Constrained Market Pricing analysis established by the ICC in 1985.[148] As an alternative method, the simplified guidelines were established in 1996 by the STB pursuant to a legislative mandate for the establishment of a "simplified and expedited method for determining the reasonableness of challenged rail rates in those cases in which a full stand-alone cost presentation is too costly,..."[149] The process of moving to a simplified method was started by the ICC before its termination and then completed by the newly created STB.

In reaching its decision that a simpler method was desirable and permissible, the ICC determined that the simplified method would not compromise the rail carrier's overall ability to earn adequate revenues (as

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[145] 49 U.S.C. § 10701 (d)(2). These are often referred to as the Long-Cannon factors after the Senators who added these factors to the Staggers Act through amendments. See *Rate Guidelines—Non-Coal Proceedings*, Ex Parte No. 347 (Sub-No. 2) (STB served December 31, 1996), p. 3, note 3.

[146] 49 U.S.C. § 10701 (d)(2).

[147] *Rate Guidelines—Non-Coal Proceedings*, Ex Parte No. 347 (Sub-No. 2) (STB served December 31, 1996), p. 4.

[148] *Coal Rate Guidelines, Nationwide*, Ex. Parte No. 347 (Sub-No. 1), 1 I.C.C. 2d 520, 521 (August 8, 1985).

[149] See 49 U.S.C. § 10701 (d)(3).

mandated by policy) because only a small portion of rail traffic could qualify for review under the simplified method. In making that determination, the ICC noted in 1995 (based on an analysis of 1993 data) that 33 percent of rail traffic revenues exceeded the 180 percent of variable cost threshold which was a necessary condition for challenging the reasonableness of a rate, however some of that traffic was exempt or under a contract rate and by ICC calculations no more than 18 percent of total revenues could be subject to challenge.[150] Moreover, it appeared that only a portion of the rate challenges would be handled under the simplified procedure; the larger cases would still be reviewed under the Constrained Market Pricing methods.[151]

After the simplified methods were established, time passed and no shipper filed a rate complaint using the simplified guidelines. The STB "held public hearings in April 2003 and July 2004 to examine why those guidelines had not been used by shippers and to explore ways to improve them."[152] In 2006, the Board launched two separate rulemakings—one with regard to the Constrained Market Pricing methodology, and the other with regard to the simplified guidelines. In October 2006, the STB modified its Constrained Market Pricing methodology for determining rate reasonableness in large cases, reduced the stand-alone cost analysis period to ten years, and adopted a uniform standard for reopening, vacating, and filing a new case.[153] In September 2007, the STB modified its simplified guidelines and also created a simplified stand-alone cost approach to be used in medium-sized disputes to challenge the reasonableness of rates.[154] In October 2007, E.I. du Pont de Nemours and Company (DuPont) filed three amended complaints challenging the reasonableness of rates charged by CSX Transportation, Inc. (CSX) for seven freight rail movements.[155] DuPont proceeded under the "Three-Benchmark method" as described below, using the newly revised simplified guidelines. On June 30, 2008, the STB's decisions were delivered on the three cases, awarding DuPont up to $3 million (the maximum award of up to $1

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[150] *Rate Guidelines—Non-Coal Proceedings*, Ex Parte No. 347 (Sub-No. 2) (STB served December 31, 1996), p. 5.

[151] *Rate Guidelines—Non-Coal Proceedings*, Ex Parte No. 347 (Sub-No. 2) (STB served December 31, 1996), p. 6.

[152] *Simplified Standards for Rail Rate Cases*, Ex Parte No. 646 (Sub-No. 1) (STB served September 5, 2007), p. 4; citing *Rail Rate Challenges In Small Cases*, STB Ex Parte No. 646 (STB served June 29, 2004) (notice of 2004 public hearing); *Rail Rate Challenges in Small Cases*, STB Ex Parte No. 646 (STB served Mar. 26, 2003) (notice of 2003 public hearing).

[153] *Major Issues in Rail Rate Cases*, Ex Parte No. 657 (Sub-No. 1) (STB served October 30, 2006), p. 4.

[154] *Simplified Standards for Rail Rate Cases*, Ex Parte No. 646 (Sub-No. 1) (STB served September 5, 2007), p. 1.

[155] *E.I. Dupont de Nemours & Co. v. CSX Transportation, Inc.*, STB Docket No. 42099 (STB served June 30, 2008); *E.I. Dupont de Nemours & Co. v. CSX Transportation, Inc.*, STB Docket No. 42100 (STB served June 30, 2008); *E.I. Dupont de Nemours & Co. v. CSX Transportation, Inc.*, STB Docket No. 42101 (STB served June 30, 2008).

million for each of the three freight rail complaint cases) and setting a rate prescription for six of the seven challenged movements. CSX has appealed the STB's decision to the U.S. Court of Appeals for the District of Columbia, stating that the rate decision was "an abuse of discretion, and not supported by substantial evidence."[156]

Constrained Market Pricing

The Constrained Market Pricing (CMP) method is the primary method used by the STB for determining the reasonableness of rates. There CMP methodology has two primary approaches: a "bottom up" approach called the Stand-Alone Cost (SAC) analysis and a "top down" approach.[157] Differential pricing and the contestability of markets are central economic tenets of Constrained Market Pricing. Differential pricing results when those shippers who are less price sensitive (e.g., captive shippers who have fewer transportation alternatives) pay more for transportation services than those who are more price sensitive (have more transportation alternatives). However, a captive shipper should not have to pay for facilities or services from which it derives no benefit (cross-subsidization). The SAC analysis provides a check on cross-subsidization.

> CMP contains three main constraints on the extent to which a railroad may charge differentially higher rates on captive traffic. The revenue adequacy constraint ensures that a captive shipper will "not be required to continue to pay differentially higher rates than other shippers when some or all of that differential is no longer necessary to ensure a financially sound carrier capable of meeting its current and future service needs." The management efficiency constraint protects captive shippers from paying for avoidable inefficiencies (whether short-run or long-run) that are shown to increase a railroad's revenue need to a point where the shipper's rate is affected. The SAC constraint protects a captive shipper from bearing costs of inefficiencies or from cross-subsidizing other traffic by paying more than the revenue needed to

[156] J. Boyd, *CSX Appeals DuPont Decision*, Traffic World Online, July 17, 2008, http://www.trafficworld.com/newssection/rail.asp?id=47087 (as viewed July 17, 2008).

[157] A "top-down" approach in a CMP analysis is one "in which a carrier's existing system is examined to determine whether it is earning sufficient funds to cover its costs and provide an adequate return on investment." *Surface Transportation Board Finds Certain Koch Pipeline Co. Rate Increases Unreasonably High, Orders Rate Rollback & Reparations*, STB News Release No. 00-22 (May 9, 2000). In this pipeline case, a top down approach was used in a CMP analysis.

> replicate rail service to a select subset of the carrier's traffic base.[158]

The SAC analysis has been the CMP methodology approach most frequently employed by shippers attempting to challenge the reasonableness of a rate. This approach assumes that the relevant market is a contestable market—with no barriers to entry or exit.

> A SAC analysis seeks to determine whether a complainant is bearing costs resulting from inefficiencies or costs associated with facilities or services from which it derives no benefit; it does this by simulating the competitive rate that would exist in a "contestable market." A contestable market is defined as one that is free from barriers to entry.[159]

A SAC analysis constructs a hypothetical stand-alone railroad (SARR) and assumes this SARR provides the challenged service. This analysis includes the development of an operating plan for the SARR's traffic and services from which investment needs and operating expenses are estimated over a specified time period.

> The analysis estimates the revenue requirements for the SARR based on the operating expenses that would be incurred over that period and the portion of capital costs that would need to be recovered during that period. A computerized discounted cash flow (DCF) model simulates how the SARR would likely recover its capital investments, taking into account inflation, Federal and state tax liabilities, and the need for a reasonable rate of return. The annual revenues required to recover the SARR's capital costs (and taxes) are combined with the

[158] *Major Issues in Rail Rate Cases*, Ex Parte No. 657 (Sub-No. 1) (STB served October 30, 2006), p. 7; citing *Coal Rate Guidelines, Nationwide*, Ex. Parte No. 347 (Sub-No. 1), 1 I.C.C. 2d 520, 535-536, 537-542, 542-546 (August 8, 1985). The ICC determined that the phasing constraint, which caps otherwise permissible rate increases, is only to be implemented when the party seeking relief demonstrates a need—when "otherwise justified rate increases could cause significant economic dislocations which must be mitigated for the greater public good." *Coal Rate Guidelines, Nationwide*, Ex. Parte No. 347 (Sub-No. 1), 1 I.C.C. 2d 520, 546 (August 8, 1985).

[159] *Major Issues in Rail Rate Cases*, Ex Parte No. 657 (Sub-No. 1) (STB served October 30, 2006), p. 7.

> annual operating costs to calculate the SARR's total annual revenue requirements.[160]

The SARR's estimated revenue requirements are compared to the expected revenue generated by the traffic group—which is calculated assuming that traffic not subject to the challenge would be at the current rates.

> The Board then compares the revenue requirements of the SARR against the total revenues to be generated by the traffic group over the SAC analysis period. Because the analysis period is lengthy, a present value analysis is used that takes into account the time value of money, netting the annual over-recovery and under-recovery as of a common point in time. If the present value of the revenues that would be generated by the traffic group is less than the present value of the SARR's revenue requirements, then the complainant has failed to demonstrate that the challenged rate levels violate the SAC constraint.
>
> If, on the other hand, the present value of the revenues from the traffic group exceeds the present value of the revenue requirements of the SARR, then the Board must decide what relief to provide to the complainant by allocating the revenue requirements of the SARR among the traffic group and over time.[161]

In the 1985 Coal Rate Guidelines, the ICC stressed that there was no one particular form for developing a SAC model, but specified the primary, required factors for any SAC analysis, including both supply and demand features.[162]

> To determine the 'supply' features of a SAC model, one must identify the types and amounts of assets required to provide the service desired and the cost of acquiring, maintaining, and operating the necessary facility. To quantify the 'demand', one must assess the type and

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[160] *Simplified Standards for Rail Rate Cases*, Ex Parte No. 646 (Sub-No. 1) (STB served September 5, 2007), p. 9.

[161] *Simplified Standards for Rail Rate Cases*, Ex Parte No. 646 (Sub-No. 1) (STB served September 5, 2007), pp. 9-10.

[162] *Coal Rate Guidelines, Nationwide*, Ex. Parte No. 347 (Sub-No. 1), 1 I.C.C. 2d 520, 543-546 (August 8, 1985).

> amount of traffic that will use the facility and the revenues to be derived.[163]

On the supply side, the hypothetical SARR is designed to minimize costs and maximize efficiency, while being optimally sized. All cost data related to the construction and operation of the hypothetical railroad must be verifiable. Indicators of required assets and potential users are given by the current carrier's facilities and customers, respectively. The SAC analysis must include a valuation of the assets composing the investment base. For this methodology, the ICC specified a valuation of assets at depreciated current costs, applying the current nominal cost of capital to the investment base in order to compute the return on investment. The SAC analysis can incorporate new as well as used assets—but it must reflect the current cost of any new asset put into use.

With regard to demand, there are no restrictions on the traffic that may be included in the SAC analysis—grouping traffic of different shippers allows the SARR to identify production economies. The revenue contribution of the traffic that is not subject to the reasonableness challenge is presumed to be at the current rates, however that presumption is rebuttable.

> In the Coal Rate Guidelines, the ICC accepted an SAC analysis that
>
> would project the stream of earnings which can be expected (based on the economic life of the assets in the investment base and the demand for service), then discount it at the current cost of capital to derive the present value of the stand-alone system. The SAC for each year would equal the difference between (1) the earnings already collected, together with those expected in future years, and (2) the total earnings stream required to cover the SAC.[164]

In 2006, the STB made several changes to the CMP methodology. The Board revised methods for the maximum rate determination, the revenue allocation for cross-over traffic, and the indexing of operating expenses. The STB also disallowed the future use of movement-specific adjustments to the URCS and shortened the SAC analysis period. In changing the way it allocated the total SAC costs to all of the SAC traffic to determine the reasonableness of the rate for the traffic at issue, the STB replaced the "percent reduction" method with the "Maximum Markup" method.

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[163] *Coal Rate Guidelines, Nationwide*, Ex. Parte No. 347 (Sub-No. 1), 1 I.C.C. 2d 520, 542 note 59 (August 8, 1985).

[164] *Coal Rate Guidelines, Nationwide*, Ex. Parte No. 347 (Sub-No. 1), 1 I.C.C. 2d 520, 545 (August 8, 1985).

> Under [the Maximum Markup methodology], the parties should use unadjusted URCS to estimate the variable cost of each movement in the traffic group, and then determine the maximum contribution of each movement towards SAC costs, expressed as a markup over variable cost. To derive the maximum contribution, the parties should first calculate the average R/VC ratio that would cover the total SAC costs in a given year. They should then check to see if the share of the SAC costs assigned to any movement in the traffic group would exceed what could actually be charged that movement. We will assume that the rates charged by the railroad for non-issue traffic reflect the profit-maximizing rates. Thus, a movement's share of the SAC costs could not be higher than what the railroad actually charges. Where the actual charge is less than the share of SAC costs that would otherwise be allocated to a particular movement, the difference should be reapportioned to the remaining traffic in the traffic group, as an appropriate application of demand-based differential pricing. This will increase the contribution level for the remaining traffic, which in turn could result in further reapportionment. This procedure should therefore be repeated, and the contribution level of the remaining traffic ratcheted upwards, until no movement in the traffic group is assigned a higher share of the SAC costs than its actual charge. Under this approach, the maximum contribution will be expressed as an R/VC ratio, so that a movement with a higher variable cost per ton would have a higher maximum contribution toward total SAC costs, and vice-versa.[165]

The STB also changed the revenue allocation for cross-over traffic in its 2006 decision. "Cross-over traffic refers to movements included in the traffic group that would be routed over the SARR for only a part of its through movement."[166] Under the SARR model, this traffic would interchange for the remainder of the movement. The STB's change addresses the assumptions regarding the division of revenues for the cross-over traffic between the SARR and the railroad providing the remainder of the movement. The STB allowed this modeling of cross-over traffic in a SAC analysis in order to make the analysis less burdensome, because as a result of the STB's decision the shipper need only calculate the subset of the total costs necessary to serve the

[165] *Major Issues in Rail Rate Cases*, Ex Parte No. 657 (Sub-No. 1) (STB served October 30, 2006), p. 14.

[166] *Major Issues in Rail Rate Cases*, Ex Parte No. 657 (Sub-No. 1) (STB served October 30, 2006), p. 24.

portion of the cross-over traffic handled by the SARR. However, the simplification associated with these more limited calculations creates a problem when apportioning the revenue for the traffic. As the STB stated, "The full SAC costs for a particular cross-over movement cannot be judged without a full SAC analysis, an undertaking that would defeat the purpose of using cross-over traffic in the first place."[167]

Historically, revenues were allocated under the "Modified Straight-Mileage Prorate" (MSP) approach. According to the STB:

> The MSP approach allocates revenues according to a crude estimate of the relative variable costs of hauling the traffic over the relevant segments, rather than the total costs. The approach therefore fails to take into account the defining characteristic of the railroad industry – economies of scale, scope and density. There is no reason to believe that economies of density in this industry have been exhausted. Yet only under such an assumption would a mileage-based approach provide an allocation based on average total costs.[168]

The STB sought public comments on an alternative for allocating cross-over revenues using an Average Total Cost (ATC) approach. "Using the URCS variable and fixed costs for the carrier, and the density and miles of each segment, parties can calculate the railroad's average total cost per segment of a move. The revenues from each portion of the movement would then be allocated in proportion to the average total cost of the movement on- and off-SARR."[169] After receiving comments and finding no superior alternative method proffered by the commenting parties, the STB adopted this new ATC approach.

In its October 2006 decision, the STB also announced it had adopted the proposed change for indexing the SARR's base year operating expenses. The RCAF is a quarterly index created to track changes in railroad costs. When created, the RCAF did not include any adjustment for changes in railroad productivity (the unadjusted RCAF-U), but in 1989 the ICC (and subsequently the STB as its successor) began including productivity gains in the RCAF

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[167] *Major Issues in Rail Rate Cases*, Ex Parte No. 657 (Sub-No. 1) (STB served October 30, 2006), p. 24.

[168] *Major Issues in Rail Rate Cases*, Ex Parte No. 657 (Sub-No. 1) (STB served October 30, 2006), p. 25 [emphasis in original]; citing *Coal Rate Guidelines, Nationwide*, Ex. Parte No. 347 (Sub-No. 1), 1 I.C.C. 2d 520, 531 (August 8, 1985); and Ivaldi & McCullough, *Density and Integration Effects of Class I U.S. Freight Railroads*, 19 J. Reg. Econ. 161 (2001).

[169] *Major Issues in Rail Rate Cases*, Ex Parte No. 657 (Sub-No. 1) (STB served October 30, 2006), p. 26; citing *Major Issues in Rail Rate Cases*, Ex Parte No. 657 (Sub-No. 1), et al. (STB served February 27, 2006), pp. 19-20.

measurement (the productivity-adjusted RCAF-A). Historically, the application of a productivity-adjusted RCAF to the SARR's operating expenses has been controversial. In 2006, the STB decided to phase in a productivity-adjusted RCAF over time under the SARR analysis—"starting with RCAF-U and phasing in the productivity gains projected in the RCAF-A incrementally [5 percent each year] over a 20-year period."[170]

The STB decided in October 2006 to discontinue the practice (established by the ICC) of allowing parties to make movement-specific adjustments to the URCS in SAC analyses. The STB opined that the use of movement-specific adjustments to the URCS added complexity, expense, and time to the SAC analysis, without a substantial offsetting benefit and in conflict with legislative intent.

> The immense costs and complexity of such adjustments to URCS conflicts [sic] with what Congress intended in adopting the 180% R/VC limitation on Board rate review: to create an administratively quick and easy-to-determine regulatory save harbor for the railroads… [The Board does] not believe that the use of movement-specific adjustments leads to a more accurate result than using the URCS system-wide average.[171]

The STB's decision on this issue was designed to simplify, expedite, and reduce the cost of future cases.

The STB's October 2006 decision also shortened the SAC analysis period and the resulting rate prescriptions from the 20-year period used historically to a 10-year period. The STB believes "that a 10-year SAC analysis period strikes the most reasonable balance. It covers an average business cycle but removes unreliable distant forecasts from our core analysis."[172] This change is also designed to simplify, expedite and reduce the cost of future SAC cases in line with the STB's interpretation of the legislative intent of the statutes.

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[170] *Major Issues in Rail Rate Cases*, Ex Parte No. 657 (Sub-No. 1) (STB served October 30, 2006), p. 40.

[171] *Major Issues in Rail Rate Cases*, Ex Parte No. 657 (Sub-No. 1) (STB served October 30, 2006), p. 51.

[172] *Major Issues in Rail Rate Cases*, Ex Parte No. 657 (Sub-No. 1) (STB served October 30, 2006), p. 64.

Simplified Methods

Simplified SAC. In September 2007, the STB created a simplified stand-alone cost approach for medium-sized rail disputes.[173] The simplified SAC approach is designed to increase the accessibility of rate relief in medium-sized disputes. Under the simplified approach, there is a focus on cross-subsidization.

> The principal objective of the SAC constraint is to restrain a railroad from exploiting market power over a captive shipper by charging more than it needs to earn a reasonable return on the replacement cost of the infrastructure used to serve that shipper. A second objective of the SAC constraint is to detect and eliminate the cost of inefficiencies in a carrier's investments or operations.
>
> It is the second objective that turns Full-SAC presentations into an intricate, expensive undertaking.[174]

The simplified SAC methodology assumes that the existing infrastructure along the route used to haul the challenged traffic is required to serve the traffic on the route. This simplifying assumption was previously considerer but rejected by the STB.

The simplified SAC approach has the following features:

- *Route*: The analysis will examine the predominant route of the issue movements during the prior 12 months for the traffic at issue.
- *Configuration*: The facilities of the SARR will consist of the existing facilities along the analyzed route (including all track, sidings, and yards). If a shipper presents compelling evidence that some facilities along the route have fallen into disuse by the railroad, and thus need not be replicated, those facilities will be excluded from the SAC analysis.
- *Test Year*: The Simplified-SAC analysis will examine the reasonableness of the challenged rates based on a 1-year analysis. The Test Year would be the most recently completed 4 quarters preceding the filing of the complaint.

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[173] *Simplified Standards for Rail Rate Cases*, Ex Parte No. 646 (Sub-No. 1) (STB served September 5, 2007). The STB has defined a medium-sized disputes eligible for relief under a simplified SAC analysis as a shipper seeking up to $5 million in relief over a 5-year period. In comparison, a small size rail rate dispute using the Three-Benchmark method would be able to recover a maximum of $1 million over a 5-year period. *Simplified Standards for Rail Rate Cases*, Ex Parte No. 646 (Sub-No. 1) (STB served September 5, 2007), p. 5.

[174] *Simplified Standards for Rail Rate Cases*, Ex Parte No. 646 (Sub-No. 1) (STB served September 5, 2007), p. 13.

- *Traffic Group*: The traffic group will consist of all movements that traveled over the selected route in the Test Year. No rerouting of traffic will be permitted.
- *Cross-Over Traffic*: The revenue from cross-over traffic will be apportioned between the on-SARR and off-SARR portions of the movement based on the revenue allocation methodology used in Full-SAC proceedings.
- *Road Property Investment*: The Board's findings in prior Full-SAC cases will be used to simplify parts of the road property investment (RPI) analysis…
- *Operating Expenses*: The total operating and equipment expenses of the SARR will be estimated using URCS. This will avoid the substantial debates over the operating plans and network configurations that consume much of a Full-SAC analysis…
- *Discounted Cash Flow Analysis*: The DCF analysis will calculate the capital requirements of a SARR in the customary fashion and then compare the revenues earned by the defendant railroad against the revenue requirements of the SARR only for the Test Year.
- *Internal Cross-Subsidy Inquiry*: The internal cross-subsidy test set forth in [*PPL Montana, LLC v. Burlington N & S.F. Ry.*, STB Docket No 42054 (STB served Aug. 20, 2002) *aff'd sub nom. PPL Montana, LLC v. STB*, 347 F.3d 1240 (D.C. Cir. 2006)], as refined in [*Otter Tail Power Co. v. BNSF Ry.*, STB Docket No. 42058, slip op. at 11-13 (STB served Jan. 27, 2006, *aff'd sub nom. Otter Tail Power Co. v. STB*, 484 F.3d 959 (8th Cir. 2007)], will be an affirmative defense, with the evidentiary burden of production and persuasion on the railroad.
- *Maximum Reasonable Rate*: The SAC costs (i.e., the revenue requirements of the SARR) will be allocated amongst the traffic group based on the methodology used in Full-SAC cases.
- *5-Year Rate Relief*: The maximum lawful rate will be expressed as a ratio of revenue to variable costs, with variable costs calculated using unadjusted URCS. This maximum R/VC ratio would then be prescribed for a maximum 5-year period.[175]

Three-Benchmark Method. The Three-Benchmark method simplified rate guidelines applying in instances where the Constrained Market Pricing guidelines cannot be practically applied for costs reasons. The guidelines apply three revenue-to-variable cost benchmark figures on a case-by-case basis: the

[175] *Simplified Standards for Rail Rate Cases*, Ex Parte No. 646 (Sub-No. 1) (STB served September 5, 2007), pp. 15-16.

$R/VC_{>180}$ benchmark, the RSAM benchmark; and the R/VC_{comp} benchmark.[176] The Three-Benchmark method provides a framework that encompasses the legislative requirements under 49 U.S.C. § 10707(d)(2). The $R/VC_{>180}$ benchmark addresses fairness principles, the RSAM measure addresses revenue adequacy and managerial efficiency, and the R/VC_{comp} benchmark addresses demand-based differential pricing.[177] In September 2007, the STB amended the 1996 Three-Benchmark method guidelines to include:

- *Waybill Sample*: provide both parties access to the unmasked Waybill sample of the defendant carrier(s), subject to customary protective orders, upon the filing of a complaint;
- *Variable Cost Calculation*: use only unadjusted URCS to calculate the variable cost of the issue movement and all movements in the comparison group;
- *Non-Defendant Traffic*: exclude non-defendant traffic from the comparison group;
- R/VC_{comp}: use a final-offer procedure to select the comparison group most similar in the aggregate to the challenged movement;
- *RSAM and* $R/VC_{>180}$: use an unadjusted RSAM figure and revise the way these benchmarks are calculated;
- *Rate Reasonableness Determination*: adjust each movement in the comparison group by the ratio of RSAM ÷ $R/VC_{>180}$, calculate a "confidence interval" around the estimate of the mean of the adjusted comparison group, and presume unreasonable a challenged rate that is above this confidence interval; and
- *Other Related Factors*: permit either the shipper or the carrier to rebut the presumption with evidence of "other relevant factors."[178]

The $R/VC_{>180}$ benchmark examines if the traffic in question comprises a disproportionate share of the carrier's revenues.

> The purpose is to consider the fairness of the defendant carrier's rate structure, as judged by Long-Cannon-3, to ensure that the complaining shipper's traffic is not bearing a disproportionate share of the carrier's revenue

[176] R/VC stands for revenue to variable cost ratio. RSAM stands for the Revenue Shortfall Allocation Method.

[177] *Rate Guidelines—Non-Coal Proceedings*, Ex Parte No. 347 (Sub-No. 2) (STB served December 31, 1996), p. 14.

[178] *Simplified Standards for Rail Rate Cases*, Ex Parte No. 646 (Sub-No. 1) (STB served September 5, 2007), pp. 16-17.

> requirements vis-à-vis other relatively demand-inelastic traffic without good cause.[179]

This is accomplished by examining the average markups applied by the carrier to other potentially captive traffic (other traffic paying rates above the $R/VC_{>180}$ benchmark). In its September 2007 decision, the $R/VC_{>180}$ ratios are calculated using the confidential Waybill Sample data as follows:

$$R/VC_{>180} = REV_{>180} \div VC_{>180}$$

where $REV_{>180}$ is the estimate of total revenue earned by the carrier on potentially captive traffic and $VC_{>180}$ is equal to the total variable costs of the railroad to handle the potentially captive traffic.

The RSAM (revenue shortfall allocation method) benchmark considers the rail carrier's total revenue needs—revenue sufficient to recover all of its URCS fixed costs, including a reasonable profit.[180] The RSAM method reflects the revenue required to provide for replacing existing assets.[181] "When a carrier is not 'revenue adequate' under the Board's annual calculations, its RSAM figure (what it needs to collect) should be greater than its $R/VC_{>180}$ figure (what it is actually collecting). Conversely, when a carrier is revenue adequate under that determination, its RSAM figure should be lower than its $R/VC_{>180}$ figure."[182] Under the pre-2007 method, the stated relationship between RSAM and $R/VC_{>180}$ did not bear out in its application. Thus, under the September 2007 rules RSAM is calculated as:

$$RSAM = \left(REV_{>180} + REV_{short/overage}\right) \div VC_{>180}$$

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[179] *Rate Guidelines—Non-Coal Proceedings*, Ex Parte No. 347 (Sub-No. 2) (STB served December 31, 1996), p. 28.

[180] The STB sought comments on a proposal to adjust the RSAM calculation methodology to account for taxes. The notice, appearing in the federal register on July 2, 2008, requested comments by August 1, 2008 and rebuttal comments by September 22, 2008. *Simplified Standards for Rail Rate Cases—Taxes in Revenue Shortfall Allocation Method*, STB Notice, Ex Parte No. 646 (Sub-No. 2) (STB served June 27, 2008).

[181] Before September 2007, the RSAM method was calculated as a range. At the lower end, the RSAM method was adjusted for all revenue shortfalls from a carrier's pricing of any of its traffic below the URCS variable cost (<100% traffic). This is referred to as the "managerial efficiency adjustment." The rationale for this adjustment was the STB's belief "that the industry had [not] yet become so efficiently sized that all of its current assets were used and useful and would warrant replacement as they wear out…" *Simplified Standards for Rail Rate Cases*, Ex Parte No. 646 (Sub-No. 1) (September 4, 2007), p. 19; citing *Rate Guidelines—Non-Coal Proceedings*, Ex Parte No. 347 (Sub-No. 2) (STB served December 31, 1996), p. 21.

[182] *Simplified Standards for Rail Rate Cases*, Ex Parte No. 646 (Sub-No. 1) (STB served September 5, 2007), p. 19.

where $REV_{>180}$ is the estimate of total revenue earned by the carrier on potentially captive traffic, $REV_{short/overage}$ is the carrier's revenue shortfall or overage shown in its annual revenue adequacy determination, and $VC_{>180}$ is equal to the total variable costs of the railroad to handle the potentially captive traffic.

The R/VC_{comp} benchmark reflects demand-based differential pricing principles. This is accomplished by measuring the markups applied to similar traffic. "The benchmark measures the markup taken on >180 traffic that involves similar commodities moving under similar transportation conditions."[183] The rationale is to compare the R/VC ratios of like traffic (other similar, potentially captive traffic).

> [C]omparability will be determined by reviewing a variety of factors, such as length of movement, commodity type, traffic densities of the likely routes involved, and demand elasticity (although the comparison group need not have movements with identical demand). The selection of the best comparison group will be governed by which group the Board concludes provides the best evidence as to the reasonable level of contribution to joint and common costs for the issue movement.[184]

In the amended Three-Benchmark method, each side proposes initial traffic for comparison from the Waybill Sample provided at the onset of the case. The parties meet and confer in a technical conference to attempt to resolve differences. Each of the parties then proposes a "final offer." The Board selects one of the final offers—the one that it concludes is most like the traffic at issue. "Each movement in the comparison group would then be adjusted by the ratio of RSAM ÷ $R/VC_{>180}$. The Board [would] then calculate the mean and standard deviation of the R/VC ratios for the adjusted comparison group (weighted in accordance with the proper sampling factors)."[185] A confidence interval for the comparison group is then constructed to determine whether the R/VC ratio for the traffic in question exceeds the upper bound of the confidence interval. If the ratio in question exceeds the confidence interval around the mean of the comparison group, the challenged rate is presumed unreasonable, absent other relevant factors. The rate would then be prescribed at the boundary level (subject to the R/VC = 180% limit), but the parties are allowed to provide evidence to argue for a rate that is higher or lower.

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[183] *Rate Guidelines—Non-Coal Proceedings*, Ex Parte No. 347 (Sub-No. 2) (STB served December 31, 1996), p. 25.

[184] *Simplified Standards for Rail Rate Cases*, Ex Parte No. 646 (Sub-No. 1) (STB served September 5, 2007), pp. 17-18.

[185] *Simplified Standards for Rail Rate Cases*, Ex Parte No. 646 (Sub-No. 1) (STB served September 5, 2007), p. 21.

Remedies

There are two remedies available to the shipper who demonstrates that a rate is not reasonable. The shipper can receive damages, based on the shipments it made during the damages period, for the amount it overpaid under 49 U.S.C. Section 11704(b). This recovery is limited in two ways. First, the "statutory 180% R/VC level is also the floor for any rate relief."[186] Second, the damages period is limited to the two-year period before the filing of the complaint per 49 U.S.C. Section 11705(c). The STB can also prescribe the maximum reasonable rate the shipper can charge for future shipments under 49 U.S.C. Section 10704(a)(1).

Rail Construction, Operation, and Acquisitions[187]

Rail service that is part of an interstate rail network falls under the authorization of the STB—including extensions of existing lines, construction of additional lines, operation of a line, or acquisition (by a party other than an existing carrier which is discussed below) of a railroad line under 49 U.S.C. Section 10901.[188] An application to authorize construction, acquisition (other than by an existing rail carrier), or operation of a rail line must be filed with the STB.[189] The STB gives public notice of the proceedings regarding these applications. There is a legislative preference in favor of granting certification—the certificate shall be issued unless the Board finds it is inconsistent with public convenience and necessity.[190] However, the STB can approve the application as is or with modifications or conditions it deems necessary in the public interest.[191] Competing railroads cannot block construction of an STB-certified activity by refusing to allow the carrier to cross its property if the carrier (either during construction or operation) does

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[186] *E.I. Dupont de Nemours & Co. v. CSX Transportation, Inc.*, STB Docket No. 42101, p. 2 (STB served June 30, 2008), citing, *Burlington N.R.R. v. STB*, 114 F.3d 206, 210 (D.C. Cir. 1997).

[187] 49 U.S.C. § 10901, 49 U.S.C. § 10902, and 49 U.S.C. §§ 11321-11328. See also, 49 C.F.R. parts 1150 and 1180.

[188] The acquisition by a different rail carrier of an active rail line owned by a rail carrier is covered by 49 U.S.C. § 11323. There are instances where the STB's authorization is not required. The STB's authorization is not needed to repair existing track. In addition, there is an exception with regard to spur, industrial, team, switching, and side tracks. The STB does not have the authority over the construction, acquisition, operation, abandonment or discontinuance of these types of tracks. Furthermore, rail carriers can enter into agreements for joint ownership or use of said tracks without approval of the STB. 49 U.S.C. § 10906. A state's acquisition of an abandoned rail lines is not subject to the jurisdiction of the STB. See 49 C.F.R. § 1150.22. Other exemptions under 49 U.S.C. §§ 10901 and 10902 are found at 49 C.F.R. pt. 1150, subparts D [§§ 1150.31-1150.36] and E [§§ 1150.41-1150.45].

[189] 49 U.S.C. § 10901 (b). Applications must include the information specified in 49 C.F.R. §§ 1150.2-1150.9.

[190] 49 U.S.C. § 10901 (c).

[191] 49 U.S.C. § 10901 (c).

not unreasonably interfere with the operation of the crossed line and the owner of the crossed line is compensated for the crossing.[192] If the amount of compensation is disputed by the parties, either may request the STB to make a determination of the appropriate compensation.[193]

Proposed acquisitions of an extended or additional rail line by a Class II or III railroad are treated under 49 U.S.C. § 10902. The STB must approve such transactions unless it finds that the proposed activities would be "inconsistent with the public convenience and necessity."[194] However, the STB again has the power to approve the application as is or with modifications or conditions it deems necessary in the public interest.

Railroad Consolidations with/by an Existing Railroad

Consolidations, mergers, purchases, leases, contracts to operate, acquisitions (of one rail carrier by another, of two rail carriers by a person who is not a rail carrier, or of trackage rights or joint ownership by a rail carrier of a line owned by another carrier) are treated under Sections 11323 through 11328 in the United States Code. The STB's approval of such transactions must be obtained in advance based on an application process that includes notice, an opportunity for comment, and a public hearing unless the Board determines this process is not in the public interest.[195]

For any merger of at least two Class I railroads, the statutes require the Board to consider:

> (1) the effect of the proposed transaction on the adequacy of transportation to the public;
> (2) the effect on the public interest of including, or failing to include, other rail carriers in the area involved in the proposed transaction;
> (3) the total fixed charges that would result from the proposed transaction;
> (4) the interest of the rail carrier employees affected by the proposed transaction; and
> (5) whether the transaction would have an adverse effect on competition among rail carriers in the affected region or in the national rail system.[196]

[192] 49 U.S.C. § 10901 (d)(1).

[193] 49 U.S.C. § 10901 (d)(2).

[194] 49 U.S.C. § 10902.

[195] 49 U.S.C. § 11324 (a).

[196] 49 U.S.C. § 11324 (b).

Under the statute, for any proposed transaction involving the merger or control of at least two Class I railroads, the STB must approve a line sale when it finds the transaction is in the public interest—although it can place conditions upon the approval.[197] For transactions that do not involve the merger or consolidation of at least two Class I railroad, the statute stipulates:

> the Board shall approve such an application unless if finds that—(1) as a result of the transaction, there is likely to be a substantial lessening of competition, creation of a monopoly, or restraint of trade in freight surface transportation in any region of the United States; and (2) the anticompetitive effects of the transaction outweigh the public interest in meeting significant transportation needs.[198]

The STB developed new rules effective as of 2001 to implement the statutory requirements for the consideration and approval of mergers. The rules that are applicable depend upon the type of transaction (major, significant, minor, or exempt).[199] In June 2001, the STB issued an opinion regarding changes to major rail consolidation procedures.[200] The STB reported:

> In March 2000, we concluded that our regulations governing applications for approval of railroad mergers, at 49 CFR part 1189, subpart A (49 CFR 1180.0—1180.9), were outdated and inadequate to address future major rail merger proposals, given the limited merger-related benefits still obtainable through the elimination of overcapacity in the industry, the significant service disruptions that had been associated with recent rail mergers and the prospect that future major merger proposals would trigger other proposals that, if approved, could result in the consolidation of the Class I railroad industry into only two North American transcontinental railroads.[201]

According to the STB, the new rules

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[197] 49 U.S.C. § 11324 (c).

[198] 49 U.S.C. § 11324 (d) [emphasis added].

[199] 49 C.F.R. § 1180.2.

[200] *Major Rail Consolidation Procedures*, STB Ex. Parte No. 582 (Sub-No. 1) (STB served June 11, 2001).

[201] *Major Rail Consolidation Procedures*, STB Ex. Parte No. 582 (Sub-No. 1) (STB served June 11, 2001), p. 8; citing *Major Rail Consolidation Procedures*, STB Ex. Parte No. 582 (Sub-No. 1) (STB served March 31, 2000), 65 FR 18021 (Apr. 6, 2000).

> reflect a significant change in the way in which we will apply the statutory public interest test to any major rail merger application. Because of the small number of remaining Class I railroads, the fact that rail mergers are no longer needed to address significant excess capacity in the rail industry, and the transitional service problems that have accompanied recent rail mergers, we believe that future merger applicants should bear a heavier burden to show that a major rail combination is consistent with the public interest. Our shift in policy places greater emphasis in the public interest assessment on enhancing competition while ensuring a stable and balanced rail transportation system.[202]

Under the STB's policy statement regarding public interest considerations, the STB believes

> that mergers serve the public interest only when the substantial and demonstrable gains in important public benefits—such as improved service and safety, enhanced competition, and greater economic efficiency—outweigh any anticompetitive effects, potential service disruptions, or other merger-related harms.[203]

The STB rules define four types of transactions: major, significant, minor and exempt. Combinations of two or more Class I railroads are "major" transactions.[204] A significant transaction is one that would not qualify as a major transaction, although it has regional or national significance.[205] If it can be determined that the transaction clearly will not have any anticompetitive effects or any anticompetitive effects will clearly be outweighed by the anticipated contribution to the public interest in meeting significant transportation needs, then the transaction is not classified as significant. If such a determination cannot be made, then it is classified as a significant

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[202] *Major Rail Consolidation Procedures*, STB Ex. Parte No. 582 (Sub-No. 1) (STB served June 11, 2001), p. 9.

[203] 49 C.F.R. § 1180.1 (c).

[204] 49 C.F.R. § 1180.2 (a). Published notice and time limits for filings and proceedings for mergers of two or more Class I railroads are specified by statute under 49 U.S.C. §§ 11325 (a)(1) and (b). The applicable statutory criteria that the STB considers regarding these transactions appears at 49 U.S.C. § 11324 (b).

[205] 49 C.F.R. § 1180.2 (b). Transactions of regional and national transportation significance are subject to different statutory procedures under 49 U.S.C. § 11325 (a)(2) [requiring published notice for transactions of regional or national significance to be decided within a specific time limit] and § 11325 (c) [specifying the time limits for filings and proceedings related to transactions with regional or national significance]. The applicable statutory criteria that the STB considers regarding a significant transaction is 49 U.S.C. § 11324 (d).

transaction. "A minor transaction is one which involves more than one railroad and which is not a major, significant or exempt transaction."[206] Exempt transactions meet the requirements for exemption under 49 U.S.C. § 10502, discussed above, and are not subject to a merger review by the STB. Currently exempted transactions are listed in 49 C.F.R. § 1180.2 (d). Application requirements for the different types of transactions are specified under 49 C.F.R § 1180.0 (a).

The STB's authority to review and approve mergers and combinations under 49 U.S.C. §§ 11322-11328 is exclusive. STB-approved consolidations are not subject to challenge under the "antitrust laws and from all other law, including State and municipal law, as necessary to let that rail carrier, corporation, or person carry out the transaction, hold, maintain, and operate property, and exercise control of franchises acquired through the transaction."[207]

Railroad Abandonment[208]

A rail carrier must also file an application with the STB if it plans to abandon or discontinue operations over any part of its line.[209] The application must include a summary of the basis for the abandonment or discontinuation, a statement that interested parties are entitled to make recommendations to the STB on the future of the rail line, and a statement with information relevant to the discontinued line's availability for sale or subsidy. In addition, there is a variety of notice requirements that the rail carrier must provide.[210] A rail carrier may abandon or discontinue operations on any part of its line only if the Board finds "that the present or future public convenience and necessity

[206] 49 C.F.R. § 1180.2 (c). Published notice and time limits for filings and proceedings for minor transactions are specified by statute under 49 U.S.C. §§ 11325 (a)(3) and (d).

[207] 49 U.S.C. § 11321.

[208] 49 U.S.C. §§ 10903 and 10904, and 49 C.F.R. pt. 1152. The STB's approval is not needed to abandon spur, industrial, team, switching, and side tracks. 49 U.S.C. § 10906.

[209] 49 U.S.C. § 10903 (a)(1).

[210] See for example, 49 U.S.C. § 10903 (a)(3) and 49 C.F.R. § 1152.20. For example, each rail carrier must maintain a current system diagram map that indicates lines that are potentially subject to abandonment or lines that the carrier intends to abandon or discontinue. 49 U.S.C. § 10903 (c). Under 49 C.F.R. § 1152.10, Class III railroads can forego a map and provide a narrative description. The carriers' maps must distinguish lines by categories—those lines which the carrier anticipates will be subject to an application within a three-year period (in red), lines potentially subject of a future abandonment (in green), lines with a pending application (in yellow), lines being operating under a continuation provision of 49 U.S.C. 10904 (in brown), and all other lines owned and operated by the carrier (in black). The system map has additional content requirements related to boundaries as by 49 C.F.R. § 1152.10. Also, an applicant must give notice of intent to file an abandonment or discontinuance application and must also notify the ten largest shippers on the line and any shipper with traffic over a specified threshold. 49 U.S.C. § 10903 (a)(3)(D); 49 C.F.R. §§ 1152.20 and 1152.2 (l).

require or permit the abandonment or discontinuance."[211] In making that determination, the Board "shall consider whether the abandonment or discontinuance will have a serious, adverse impact on rural and community development."[212]

The statutes also provide a mechanism for financial assistance in the form of a subsidy for or an acquisition of the line at issue. In a case where a party is considering an offer of financial assistance to the filing rail carrier, the rail carrier must provide information to both the offering party and the STB, including an estimate of the annual subsidy and minimum purchase price to keep the line at issue in operation as well as data and other information to allow the potential offeror to calculate a subsidy or offer.[213]

The STB has used its exemption mandate at 49 U.S.C. § 10502 to make the abandonment process more efficient.

> The Board has used this exemption power to simplify and expedite abandonment cases where it believes that closer regulatory scrutiny is unnecessary, and most requests for abandonment authority are now handled through the exemption process. A carrier seeking abandonment authority may petition the Board for an exemption for a particular line on a case-by-case basis.[214]

There is also an abandonment exemption for inactive lines.

> [I]f no local traffic has moved over the line in at least 2 years, any overhead traffic can be rerouted, and no formal complaint filed by a user regarding cessation of service over the line is pending or has been decided against the railroad during the 2-year period, a carrier may utilize a class exemption for "out-of-service lines."[215]

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[211] 49 U.S.C. § 10903 (d). Note that if an abandonment application is filed by a bankrupt railroad, the Board's action on the abandonment application is only advisory. See, for example, 49 C.F.R. § 1152.26 (b).

[212] 49 U.S.C. § 10903 (d).

[213] 49 U.S.C. § 10904 (b).

[214] *Class Exemption for Expedited Abandonment Procedure for Class II and Class III Railroads*, Ex Parte No. 647 (STB served December 15, 2006), pp. 2-3, citing 49 CFR § 1152.60.

[215] *Class Exemption for Expedited Abandonment Procedure for Class II and Class III Railroads*, Ex Parte No. 647 (STB served December 15, 2006) p. 3; citing 49 CFR § 1152.50 (b); *Exemption of Out of Service Rail Lines*, 2 I.C.C.2d 146, 157-58 (1986), *aff'd sub nom. Illinois Commerce Comm'n v. ICC*, 848 F.2d 1246 (D.C. Cir. 1988) (*Out-of-Service Exemption*).

There is a limited period after the notice of the filing of the application for potential offerors to make an offer to purchase or subsidize the line at issue and for the parties to reach an agreement.[216] If the offer is less than the rail carrier's estimate, then the offer must explain the basis of the difference and how the offer is calculated.[217] If there is an offer but the parties cannot reach agreement within the specified period, then either party can request that the Board establish the conditions and amount of compensation, subject to certain restrictions.[218] If there is more than one offer, the rail carrier decides which offer it wants to accept. If the parties are unable to reach an agreement within the allotted timeframe and the original offer is withdrawn, then other parties responding within the offer period may accept the Board's determination of compensation (subject to restrictions on calculation methodology) and the Board shall require the rail carrier to enter into a subsidy or sale agreement.[219] There are time limitations and other restrictions on a purchaser's ability to dispose of the rail line once acquired as well as a time limitation on the length of a subsidy unless agreed to by both parties.[220]

If there are no offers from a financially responsible person or entity, then within fifteen days of the expiration of the four-month period (shorter if STB has granted an exemption), the STB can approve the application for railroad property abandonment or discontinuance as filed or with modifications, or it can deny the application if it fails to find public convenience or necessity.[221] When the STB approves an application for abandonment or discontinuance, the STB must determine whether the rail properties involved are appropriate for public purposes and not required for continued rail operations.[222] If deemed appropriate for public purposes, then the Board can place conditions on the disposal of the involved properties by the rail carrier.[223]

The STB, under specific circumstances and where public convenience and necessity require or permit it, can require a rail carrier to sell a line that has been identified by the rail carrier as subject to abandonment or discontinuance to a financially responsible person for not less than the constitutionally minimum value.[224] The constitutionally minimum value is the greater of the

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[216] 49 U.S.C. §§ 10904 (c) and (f)(3) and 49 C.F.R. § 1152.27 (b). This period may be abbreviated if the STB has granted an abandonment exemption under 49 U.S.C. § 10502

[217] 49 U.S.C. § 10904 (c).

[218] 49 U.S.C. §§ 10904 (e) and (f).

[219] 49 U.S.C. § 10904 (f)(3).

[220] 49 U.S.C. § 10904 (f)(4).

[221] 49 U.S.C. §§ 10904 (d) and 10903 (e).

[222] 49 U.S.C. § 10905 and 49 C.F.R. § 1152.28. 49 C.F.R. § 1152.29 contains procedures for interim trail use and rail banking.

[223] 49 U.S.C. § 10905 and 49 C.F.R. § 1152.28 (b).

[224] 49 U.S.C. § 10907 (b).

net liquidation value of the line or the going concern value of the line. Public convenience and necessity require or permit the sale of a railroad line if the STB determines after a hearing that the rail carrier refuses to make necessary efforts to provide adequate service over the line, transportation over the line is inadequate for the majority of shippers, the sale will not have a significantly adverse financial effect on the carrier, the sale will not have an adverse effect on the overall operational performance of the carrier, and the sale will likely result in improved transportation for shippers over the line.[225]

The Interchange of Traffic[226]

A rail carrier must "provide reasonable, proper and equal facilities that are within its power to provide for the interchange of traffic…."[227] Rail carriers are also authorized to establish through routes with each other and water carriers, and to establish rules, provide facilities, and reasonable compensation for their operation.[228] The STB may only require a rail carrier to establish a through route that includes substantially less than the entire length of its railroad and any intermediate railroad operated under its management when:

> (A) required under section 10741 [prohibitions against discrimination by rail carriers], 10742 [facilities for interchange of traffic], or 11102 [use of terminal facilities] of [Title 49];
> (B) inclusion of those lines would make the through route unreasonably long when compared with a practicable alternative through route that could be established; or
> (C) the Board decides that the proposed through route is needed to provide adequate, and more efficient or economic, transportation.[229]

Rail carriers must construct, maintain, and operate, on reasonable conditions, switch connections and tracks upon the request of an owner of a lateral branch or a shipper "when the connection (1) is reasonably practicable; (2) can be made safely; and (3) will furnish sufficient business to justify its construction and maintenance."[230] If a rail carrier fails to provide a switch connection after such a request, a complaint for relief can be filed with the

[225] 49 U.S.C. § 10907 (c)(1).

[226] 49 U.S.C. §§ 11102 and 11103.

[227] 49 U.S.C. § 10742.

[228] 49 U.S.C. § 10703.

[229] 49 U.S.C. § 10705 (a)(2).

[230] 49 U.S.C. § 11103 (a).

STB.[231] The STB must investigate the complaint and may direct the rail carrier to provide the switch connection only after a full hearing.

Under certain circumstances, the STB may also require the use of one rail carrier's terminal facilities (and main tracks for a distance outside of the terminal) by another rail carrier. The Board may require the use of terminal facilities by another carrier where it finds such use "to be practicable and in the public interest without substantially impairing the ability of the rail carrier owning the facilities or entitled to use the facilities to handle its own business." The rail carriers involved determine the compensation for such use unless they can't reach an agreement, in which case the STB may do so "under the principle of controlling compensation in condemnation proceedings."[232]

The STB may require rail carriers to enter into reciprocal switching agreements where such agreements are "practicable and in the public interest, or where such agreements are necessary to provide competitive rail service."[233] The rail carriers determine the compensation under these agreement, however if they cannot agree then the STB may determine the compensation and conditions.

The STB has implemented rules governing petitions for through routes, through rates, and reciprocal switching.[234] Before a rail carrier files for a STB-prescribed through route, joint rate, or reciprocal switching, it must first attempt negotiations with the rail carrier in question.[235] Parties may use arbitration in the negotiation process.[236] The STB will prescribe a through route, through rate, or switching arrangement if 1) the Board finds the action meets the criteria of § 10705 (for through routes or through rates) or § 11102 (for reciprocal switching), 2) it is also necessary in order "to remedy or prevent an act that is contrary to the competition policies of 49 U.S.C. 10101 or is otherwise anticompetitive…" <u>and</u> 3) the complaining party had or would use the through route, through rate, or reciprocal switching for a significant amount of its traffic (rail carrier) or transportation needs (shipper).[237] In determining the potential anticompetitive impact, the Board considers all relevant factors including the revenues of the railroads involved, the efficiency of the rail routes involved (including operating costs), rates or compensation charged by the rail carrier from whom the prescription is being sought, and the revenue, cost, and the ratio thereof for the traffic that would result. A loss of revenue to an affected carrier is not alone a basis for establishing a through route, through

[231] 49 U.S.C. § 11103 (b). The complaint is filed with the STB under 49 U.S.C. § 11701.

[232] 49 U.S.C. § 11102 (a).

[233] 49 U.S.C. § 11102 (c)(1).

[234] 49 C.F.R. § 1144.

[235] 49 C.F.R. § 1144.1.

[236] 49 C.F.R. § 1144.1 (c).

[237] 49 C.F.R. § 1144.2 (a).

rate, or reciprocal switching agreement in order to "remedy or prevent an act contrary to the competitive standards of [Section 1142.2(a)(1)(iv)]."[238] In these proceedings, the STB does not consider product competition but may consider a rail carrier's clear and convincing evidence of geographic competition.[239] When the STB determines that a prescribed through route, through rate, or reciprocal switching agreement is necessary, it may not deny the prescription due to the revenue inadequacy of the defendant rail carrier.[240]

If, upon a complaint, the STB finds that a rail carrier is in violation of the statutes, the STB can compel its compliance.[241] Under certain circumstances, the Board can also prescribe alternative rail service for a rail carrier's failures under 49 U.S.C. §§ 11102 or 10705 upon a specific, detailed petition for relief from shippers or other rail carriers.[242] The Board can prescribe alternative rail service when it makes a determination that "over an identified period of time, there has been a substantial, measureable deterioration or other demonstrated inadequacy in rail service provided by the incumbent carrier."[243] If relief is granted and the STB prescribes alternative services, the incumbent rail carrier may file to terminate the relief with evidence demonstrating that it is prepared to meet the statutory service requirements.[244]

A number of cases, referred to as the "bottleneck" cases, have been filed by shippers seeking relief for service routes involving a bottleneck segment—where a portion of the route is served by multiple carriers, but some bottleneck segment of the route is served by only one carrier—to "counter what [the shippers] perceive[d] as the bottleneck carriers' [then] undue market power…" over shipments.[245] For example, in *Central Power & Light Co. v. Southern Pacific Transportation Co., et al.*, the shipper utilities,

> relying upon a rail carrier's obligations…to maintain reasonable interchanges with other rail carriers and accept all traffic reasonably tendered to them, [sought] to have each bottleneck carrier provide (and if necessary have the Board prescribe) a trainload or unit-train local rate for

[238] 49 C.F.R. § 1144.2 (a)(1)(iv).

[239] 49 C.F.R. § 1144.2 (b)(1) and (2).

[240] 49 C.F.R. § 1144.2 (b)(3).

[241] 49 U.S.C. § 11701 (a).

[242] 49 C.F.R. § 1147.1 (a). 49 C.F.R. § 1147.1 (b)(1) contains the requirements for the petition for relief.

[243] 49 C.F.R. § 1147.1 (a).

[244] 49 C.F.R. § 1147.1 (c)(1).

[245] *Central Power & Light Co. v. Southern Pacific Transportation Co., et al.*, STB Docket No. 41242 et al., Decision (STB served December 27, 1996), p. 2.

> transportation over the bottleneck segment of the designated route from an interchange point of the shipper's choosing.[246]

The STB refused to order the rail carrier to establish a local rate for the bottleneck segment, stating that shippers "may not unilaterally dictate the terms of service through artifices such as a request for a local rate for what is clearly a through movement."[247] Additionally, in acknowledging its duty to assist rail carriers to earn adequate revenues, the Board recognized that a rail carrier's ability to implement differential pricing is necessary to earn adequate revenues, thus the Board declined to prescribe a local rate for the captive shippers.[248]

The Board also refused to order the bottleneck carriers to establish such a rate from an interchange point of the shipper's choosing, stating that "through the [4-R Act] and the [Staggers Act], Congress ended the 'open-routing' system that effectively had required rail carriers to establish and maintain interchanges and through routes 'on practically all combinations of railroad tracks between two points.'"[249] Although the Board is authorized to "prescribe additional through routes 'when it considers it desirable in the public interest,'" it concluded that the shippers did not fulfill their obligation to "show that a carrier 'has used its market power to extract unreasonable terms on through movements, or, [] because of its monopoly position, has shown a disregard for the shipper's needs by rendering inadequate service.'"[250]

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[246] *Central Power & Light Co. v. Southern Pacific Transportation Co., et al.*, STB Docket No. 41242 et al., Decision (STB served December 27, 1996), p. 2. Rail carrier's obligations are found under 49 U.S.C. §§ 10742 and 11101 (a).

[247] *Central Power & Light Co. v. Southern Pacific Transportation Co., et al.*, STB Docket No. 41242 et al., Decision (STB served December 27, 1996), p. 7.

[248] *Central Power & Light Co. v. Southern Pacific Transportation Co., et al.*, STB Docket No. 41242 et al., Decision (STB served December 27, 1996), p. 13, note 21, p. 14, and p. 21.

[249] *Central Power & Light Co. v. Southern Pacific Transportation Co., et al.*, STB Docket No. 41242 et al., Decision (STB served December 27, 1996), p. 6; citing, *Baltimore Gas & Electric Co. v. United States*, 817 F.2d at 110 (D.C. Cir. 1987).

[250] *Central Power & Light Co. v. Southern Pacific Transportation Co., et al.*, STB Docket No. 41242 et al., Decision (STB served December 27, 1996), p.7; citing 49 U.S.C. 10747 (a)(1); and *Midtec Paper Corp. v. Chicago & N.W. Transp. Co.*, 3 I.C.C.2d 1771, 181 (1986), *aff'd sub nom. Midtec Paper Corp. v. United States*, 857 F.2d 1487 (D.C. Cir. 1988).

Chapter 21 Contents

CHAPTER 21 DESCRIPTION OF RECENT RAILROAD INDUSTRY POLICY PROPOSALS 21-1

INTRODUCTION 21-1
21A. DESCRIPTION OF POLICY CHANGES DISCUSSED IN THE GAO REPORT 21-1
Bottleneck Rates 21-2
Reciprocal Switching 21-5
Terminal Agreements 21-7
Trackage Rights 21-9
Interchange Commitments 21-10
STB Reforms 21-15
21B. ANTITRUST REFORM 21-20
Current Antitrust Immunity for Railroads 21-20
Suggested Effects of Antitrust Immunity 21-22
The Railroad Antitrust Enforcement Act (S. 772, H.R. 1650) 21-24
Committee Hearings 21-25
21C. INVESTMENT TAX CREDIT 21-26
21D. SUMMARY OF STAKEHOLDER FEEDBACK ON POLICY PROPOSALS 21-28
Legislative Proposals 21-28
STB Reforms 21-29
CONCLUSION 21-30

LIST OF FIGURES

FIGURE 21-1 GAO BOTTLENECK RATE ILLUSTRATION 21-3
FIGURE 21-2 GAO RECIPROCAL SWITCHING ILLUSTRATION 21-6
FIGURE 21-3 GAO TERMINAL AGREEMENTS ILLUSTRATION 21-8
FIGURE 21-4 GAO TRACKAGE RIGHTS ILLUSTRATION..... 21-10
FIGURE 21-5 GAO INTERCHANGE COMMITMENT ILLUSTRATION 21-12

CHAPTER 21
DESCRIPTION OF RECENT RAILROAD INDUSTRY POLICY PROPOSALS

INTRODUCTION

This chapter describes recent policy proposals to change the railroad industry, many of which were discussed in the 2006 GAO report on the U.S. railroad industry.[1] We describe the changes discussed in that report and proposed in recent bills before Congress—in particular S. 953 and H.R. 2125, The Railroad Competition and Service Improvement Act of 2007. In addition to the proposals discussed in the GAO report, we also describe other recently proposed bills that reconsider the railroad industry's antitrust exemptions (S. 772, H.R. 1650) as well as bills that propose investment tax credits for the railroad industry (S. 1125, H.R. 2116). Chapter 22 presents an economic analysis of the various recent policy proposals.

21A. DESCRIPTION OF POLICY CHANGES DISCUSSED IN THE GAO REPORT

The potential reforms discussed in the 2006 GAO report include changes in policies regarding: bottleneck rates, reciprocal switching, terminal agreements, trackage rights, interchange commitments (paper barriers), and the STB's procedures relating to the railroad industry. Except for the trackage rights issue, potential changes for all of these policy areas are contained in recent legislative proposals. Below, we discuss the GAO's description of the contemplated reforms and the

[1] Government Accountability Office Report to Congressional Requesters, "Freight Railroads Industry Health Has Improved, but Concerns about Competition and Capacity Should Be Addressed," October 2006. In this chapter, we refer to this GAO report as "the 2006 GAO report" or simply "the GAO report."

legislation (specifically, The Railroad Competition and Service Improvement Act of 2007) proposed to implement these changes.[2]

Bottleneck Rates

The GAO report explains that bottlenecks arise where:

> Some shippers have more than one railroad that serves them at their origin and/or destination points, but have at least one portion of a rail movement for which no alternative rail route is available. This portion is referred to as the "bottleneck segment."[3]

Figure 21-1 duplicates the GAO's illustration of a railroad bottleneck. In this figure, Railroad 1 serves the entire movement, A to C, which is composed of segments, A to B and B to C. Railroad 2 serves only segment B to C of the entire A to C movement. Thus, A to B is a bottleneck served by only Railroad 1. Under most circumstances, Railroad 1 will only quote a rate for the entire route, A to C, and will not, nor is it required to, quote a rate for the smaller segment, A to B, where it has exclusivity. A rate for the A to B "bottleneck" segment is known as a "bottleneck rate."

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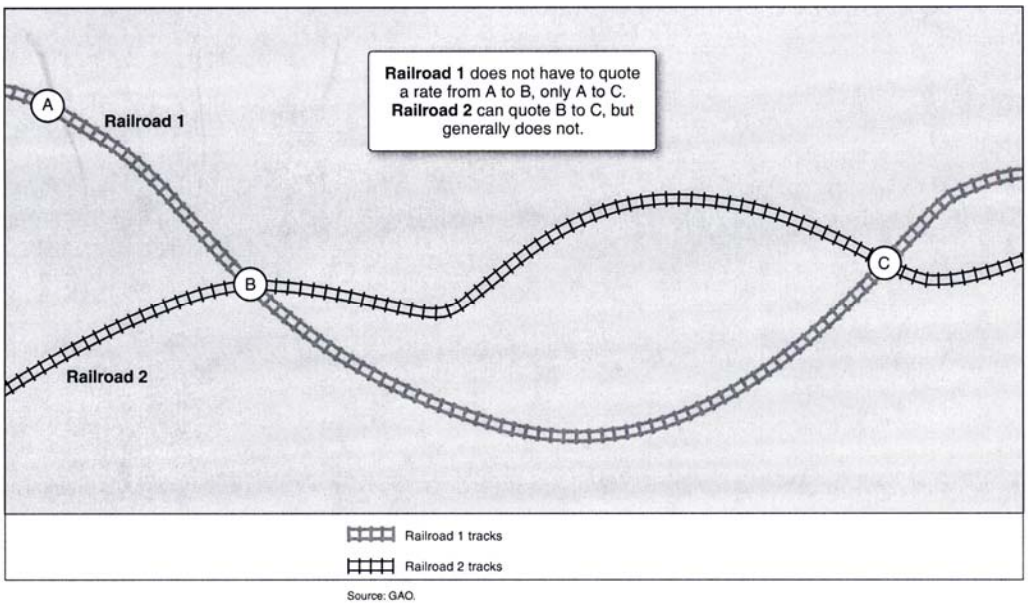
[2] We focus on those sections of the proposed legislation that refer to the policy reforms discussed in the 2006 GAO report. However, there are other industry reforms proposed in the legislation that are not discussed here. For example, among its other provisions, S. 953:

- Requires the Board to designate any state or substantial part of a state as an area of inadequate rail competition after making certain findings.
- Requires the Board to post rail service complaints on its website.
- Specifies time limits for STB action on complaints seeking injunctive relief alleging unlawfulness of a new or revised rail rate, rule, or practice.
- Establishes the Office of Rail Customer Advocacy.
- Authorizes the Board to investigate rail carrier violations on its own initiative and requires the Board to initiate an investigation upon receiving a complaint alleging rail carrier violations.

See S. 953, 110th Congress, 1st Sess. § 105, § 201(a), § 201(c), § 204, and § 401 (2007).

[3] Government Accountability Office Report to Congressional Requesters, "Freight Railroads Industry Health Has Improved, but Concerns about Competition and Capacity Should Be Addressed," October 2006, pp. 48-49.

FIGURE 21-1
GAO BOTTLENECK RATE ILLUSTRATION[4]



The STB has ruled that rail carriers are not required to provide rates for the bottleneck segments pursuant to the rail carriers' discretion to set rates and specify routes under Title 49 United States Code Sections 10701(c) and 10705(a), respectively.[5] According to the GAO report:

STB's rationale was that statute and case law precluded it from requiring a railroad to provide service on a portion of its route when the railroad serves both the origin and destination points and provides a rate for such movement. STB requires a railroad to provide service for the bottleneck segment only if the shipper had prior arrangements or a contract for the remaining portion of the shipment route.[6] A Congressional Research Service report further elaborates on the STB's rationale.

> Bottleneck rate practices were affirmed by the STB in December 1996 in its ruling on three coal rate cases brought by several utilities. The STB ruled that

[4] Government Accountability Office Report to Congressional Requesters, "Freight Railroads Industry Health Has Improved, but Concerns about Competition and Capacity Should Be Addressed," October 2006, p. 50, Figure 24.

[5] *Central Power & Light Co. v. Southern Pacific Transportation Co., et al.*,1 STB 1059 (1996) ("Bottleneck I"), modified in part, 2 STB 235 (1997) ("Bottleneck II"), aff'd *sub nom. MidAmerican Energy Co. v. STB*, 169 F.3d 1099 (8th Cir. 1999), cert. denied, 528 U.S. 950.

[6] Government Accountability Office Report to Congressional Requesters, "Freight Railroads Industry Health Has Improved, but Concerns about Competition and Capacity Should Be Addressed," October 2006, p. 49.

> railroads did not have to "short-haul" themselves by offering rates on only a portion of a route if they could serve the entire route. The Board cited the section of statute that states that a rail carrier may establish "any rate for transportation or service." The Board decided that a railroad only has to offer a rate on the one route the railroad deems most efficient for handling the cargo. A railroad does not have to offer rates for any alternative routes that the shipper requests. The STB did establish an exception to this ruling. If a shipper has already entered into a contract with the non-bottleneck carrier for the non-bottleneck portion of the route …, then the bottleneck railroad … must in fact segment the route and offer a separate rate for the bottleneck (short-haul) portion of the shipment. In practice, however, the non-bottleneck railroad generally has not entered into a contract with a shipper under these circumstances.[7]

The proposed policy change would require a railroad carrier serving a bottleneck segment as part of a longer movement to offer a rate and service for the shorter, bottleneck segment. There are costs and benefits of establishing such a policy. As characterized by the GAO:

> On the one hand, requiring railroads to establish bottleneck rates would force short-distance routes on railroads when they served an entire route and could result in loss of business and potentially subject the bottleneck segment to a rate complaint. On the other hand, this approach would give shippers access to a second railroad, even if a single railroad was the only railroad that served the shipper at its origin and/or destination points, and could potentially reduce rates.[8]

H.R. 2125 and S. 953 would require railroads to provide a rate between any two points on their networks, including any bottleneck segment of a

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[7] John Frittelli, "Railroad Access and Competition Issues," CRS Report for Congress, Order Code RL34117, updated January 10, 2008, p. 5, citing *Central Power & Light Co. v. Southern Pacific Transportation Co., et al.*, 1 STB 1059 (1996) ("Bottleneck I"), modified in part, 2 STB 235 (1997) ("Bottleneck II"), *aff'd sub nom. MidAmerican Energy Co. v. STB*, 169 F.3d 1099 (8th Cir. 1999), cert. denied, 528 U.S. 950; and 49 U.S.C. § 10701 (c).

[8] Government Accountability Office Report to Congressional Requesters, "Freight Railroads Industry Health Has Improved, but Concerns about Competition and Capacity Should Be Addressed," October 2006, p. 49.

route.[9] For example, S. 953 (The Railroad Competition and Service Improvement Act of 2007) would amend Section 11101(a) of Title 49, United States Code by adding the following paragraph:

> (2) Upon the request of a shipper, a rail carrier shall establish a rate for transportation and provide service requested by the shipper between any 2 points on the system of that carrier at which traffic originates, terminates, or may reasonably be interchanged. A carrier shall establish a rate and provide service upon such request without regard to—
>
> (A) the location of the movement on the rail system, including terminal areas;
> (B) whether the rate established is for part of a movement between a point of origin and a destination;
> (C) whether the shipper has made arrangements for transportation for any other part of that movement; or
> (D) whether the shipper has a contract with any rail carrier for part or all of its transportation needs over the route of movement. [10]

Reciprocal Switching

The GAO report describes the reciprocal switching issue as requiring

> railroads serving shippers that are close to another railroad to transport cars of a competing railroad for a fee. The shippers would then have access to railroads that do not reach their facilities. This approach is similar to the mandatory interswitching in Canada, which enables a shipper to request a second railroad's service if that second railroad is within approximately 18 miles. Some Class I railroads already interchange traffic using these agreements, but they oppose being required to do so. Under this approach, STB would oversee the pricing of switching agreements.[11]

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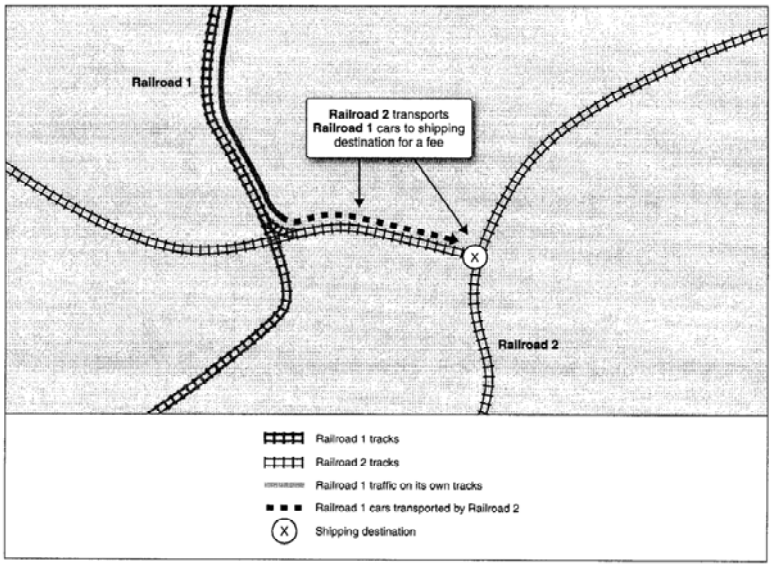
[9] John Frittelli, "Railroad Access and Competition Issues," CRS Report for Congress, Order Code RL34117, updated January 10, 2008, p. 6.

[10] S. 953, 110th Congress, 1st Sess. § 102 (2007).

[11] Government Accountability Office Report to Congressional Requesters, "Freight Railroads Industry Health Has Improved, but Concerns about Competition and Capacity Should Be Addressed," October 2006, p. 44.

In Figure 21-2, Railroad 1's tracks do not reach shipping destination X, which is located on Railroad 2's tracks. With a reciprocal switching arrangement, Railroad 2 would transport Railroad 1's cars to shipping destination X for a fee. The potential benefit of reciprocal switching is that it "could also reduce the number of captive shippers by providing a competitive option to shippers with access to a proximate but previously inaccessible railroad and thereby reduce traffic eligible for the rate relief process."[12]

FIGURE 21-2
GAO RECIPROCAL SWITCHING ILLUSTRATION[13]



Source: GAO.

Section 104 of S. 953 amends Section 11102(c) of Title 49, United States Code to read:

> (c) (1) The Board shall require rail carriers to enter into reciprocal switching agreements, if the Board determines such agreements to be practicable and in the public interest, or if such agreements are necessary to provide competitive rail service. The rail carriers entering into such an agreement shall establish the conditions and compensation applicable

[12] Government Accountability Office Report to Congressional Requesters, "Freight Railroads Industry Health Has Improved, but Concerns about Competition and Capacity Should Be Addressed," October 2006, p. 44.

[13] Government Accountability Office Report to Congressional Requesters, "Freight Railroads Industry Health Has Improved, but Concerns about Competition and Capacity Should Be Addressed," October 2006, p. 45, Figure 21.

> to such agreement. If the rail carriers cannot agree upon such conditions and compensation within a reasonable period of time, the Board shall establish such conditions and compensation.
> (2) The Board may require reciprocal switching agreements entered into by rail carriers pursuant to this subsection to contain provisions for the protection of the interests of employees affected thereby.
> (3) In making any finding under paragraph (1), the Board may not require evidence of anticompetitive conduct by a rail carrier from which access is sought.[14]

Terminal Agreements

The GAO report describes terminal agreements as requiring "one railroad to grant access to its terminal facilities or tracks to another railroad, enabling both railroads to interchange traffic or gain access to traffic coming from shippers off the other railroad's lines for a fee."[15] In Figure 21-3, Railroad 1's tracks do not reach a terminal area served by Railroad 2's tracks. A terminal agreement would allow Railroad 1 access to Railroad 2's tracks to serve its terminal area and facilities. Under the current statute, railroads aren't required to allow another railroad access to its terminals and tracks. The GAO report describes today's policy relating to terminal agreements in contrast to a changed approach.

> Current regulation requires a shipper to demonstrate anticompetitive conduct by a railroad before STB will grant access to a terminal by a nonowning railroad unless there is an emergency or when a shipper can demonstrate poor service and a second railroad is willing and able to provide the service requested. This approach would require revisiting the current requirement that railroads or shippers demonstrate anticompetitive conduct in making a case to gain access to a railroad terminal in areas where there is inadequate competition.[16]

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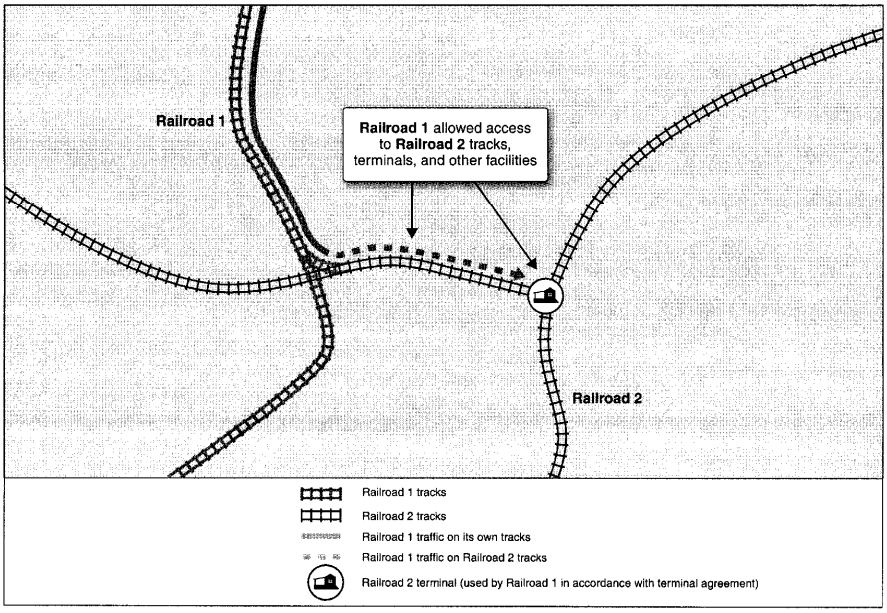
[14] S. 953, 110th Congress, 1st Sess. § 104 (2007).

[15] Government Accountability Office Report to Congressional Requesters, "Freight Railroads Industry Health Has Improved, but Concerns about Competition and Capacity Should Be Addressed," October 2006, p. 45.

[16] Government Accountability Office Report to Congressional Requesters, "Freight Railroads Industry Health Has Improved, but Concerns about Competition and Capacity Should Be Addressed," October 2006, pp. 45-46.

FIGURE 21-3
GAO TERMINAL AGREEMENTS ILLUSTRATION[17]



Source: GAO.

The potential benefits of terminal agreement policy changes are that they "would…make it easier for competing railroads to gain access to the terminal areas of other railroads and could increase competition between railroads… [and] shippers could benefit from increased competition…"[18] The potential cost, however, is that terminal agreement policy changes "could also reduce revenues to all railroads involved and adversely affect the financial condition of the rail industry…[and] shippers…might see service decline."[19]

Under the current proposed bills, S. 953 and H.R. 2125, Sections 11102(a) and (b) of Title 49, United States Code would remain unchanged. These sections would continue to read as follows:

> (a) The Board may require terminal facilities, including main-line tracks for a reasonable distance outside of a terminal, owned by a rail carrier

[17] Government Accountability Office Report to Congressional Requesters, "Freight Railroads Industry Health Has Improved, but Concerns about Competition and Capacity Should Be Addressed," October 2006, p. 47, Figure 22.

[18] Government Accountability Office Report to Congressional Requesters, "Freight Railroads Industry Health Has Improved, but Concerns about Competition and Capacity Should Be Addressed," October 2006 p. 46.

[19] Government Accountability Office Report to Congressional Requesters, "Freight Railroads Industry Health Has Improved, but Concerns about Competition and Capacity Should Be Addressed," October 2006, p. 46.

> providing transportation subject to the jurisdiction of the Board under this part, to be used by another rail carrier if the Board finds that use to be practicable and in the public interest without substantially impairing the ability of the rail carrier owning the facilities or entitled to use the facilities to handle its own business. The rail carriers are responsible for establishing the conditions and compensation for use of the facilities. However, if the rail carriers cannot agree, the Board may establish conditions and compensation for use of the facilities under the principle controlling compensation in condemnation proceedings. The compensation shall be paid or adequately secured before a rail carrier may begin to use the facilities of another rail carrier under this section.
> (b) A rail carrier whose terminal facilities are required to be used by another rail carrier under this section is entitled to recover damages from the other rail carrier for injuries sustained as the result of compliance with the requirement or for compensation for the use, or both as appropriate, in a civil action, if it is not satisfied with the conditions for use of the facilities or if the amount of the compensation is not paid promptly.[20]

Trackage Rights

The GAO report describes trackage rights as requiring

> one railroad to grant access to its tracks to another railroad, enabling railroads to interchange traffic beyond terminal facilities for a fee. In the past, STB has imposed conditions requiring that a merging railroad must grant another railroad trackage rights to preserve competition when a merger would reduce a shipper's access to railroads from two to one.[21]

A potential policy change regarding trackage rights would allow one carrier to use the tracks of another for a fee. The potential benefits of requiring railroads to grant trackage rights are that it may increase rail

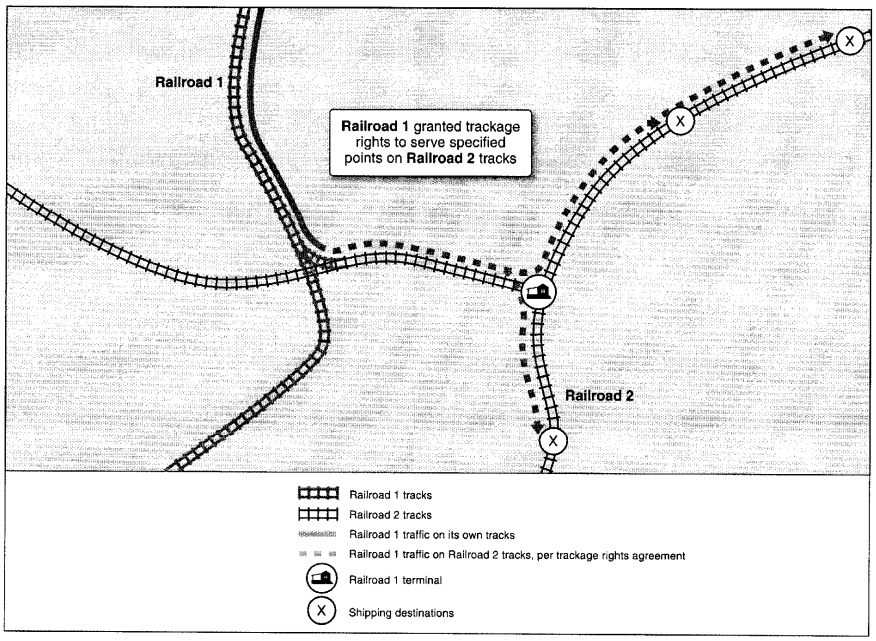
[20] 49 U.S.C. §§ 11102 (a) and (b).

[21] Government Accountability Office Report to Congressional Requesters, "Freight Railroads Industry Health Has Improved, but Concerns about Competition and Capacity Should Be Addressed," October 2006, p. 47.

competition and decrease rates, however the potential costs are that "it could also discourage owning railroads from maintaining the track or providing high-quality service, since the value of lost use of track may not be compensated by the user fee and may decrease return on investment."[22]

In Figure 21-4, potential trackage rights would allow Railroad 1 to serve specified points on Railroad 2's network. None of the recently proposed legislation provides for a change to the STB's current policy on trackage rights.

FIGURE 21-4
GAO TRACKAGE RIGHTS ILLUSTRATION[23]



Source: GAO.

Interchange Commitments

The GAO report discusses potential changes to interchange commitments (commonly termed "paper barriers") as follows:

> This approach would prevent or, put a time limit on, paper barriers, which are contractual agreements that can occur when a Class I railroad either sells or

[22] Government Accountability Office Report to Congressional Requesters, "Freight Railroads Industry Health Has Improved, but Concerns about Competition and Capacity Should Be Addressed," October 2006, pp. 47-48.

[23] Government Accountability Office Report to Congressional Requesters, "Freight Railroads Industry Health Has Improved, but Concerns about Competition and Capacity Should Be Addressed," October 2006, p. 48, Figure 23.

> leases long term some of its track to other railroads (typically a short-line railroad and/or regional railroad). These agreements stipulate that virtually all traffic that originates on that line must interchange with the Class I railroad that originally leased the tracks or pay a penalty. Since the 1980s, approximately 500 short lines have been created by Class I railroads selling a portion of their lines; however, the extent to which paper barriers are a standard practice is unknown because they are part of confidential contracts. When this type of agreement exists, it can inhibit smaller railroads that connect with or cross two or more Class I rail systems from providing rail customers access to competitive service. Eliminating paper barriers could affect the railroad industry's overall capacity since Class I railroads may abandon lines instead of selling them to smaller railroads and thereby increase the cost of entering a market for a would-be competitor. In addition, an official from a railroad association told us that it is unclear if a federal agency could invalidate privately negotiated contracts.[24] In Figure 21-5 Railroad 1 (a Class II or III railroad) and Railroad 2 (a Class I railroad) have a contractual agreement, or an interchange commitment, which prevents Railroad 1 from interchanging traffic with other railroads, such as Railroad 3.

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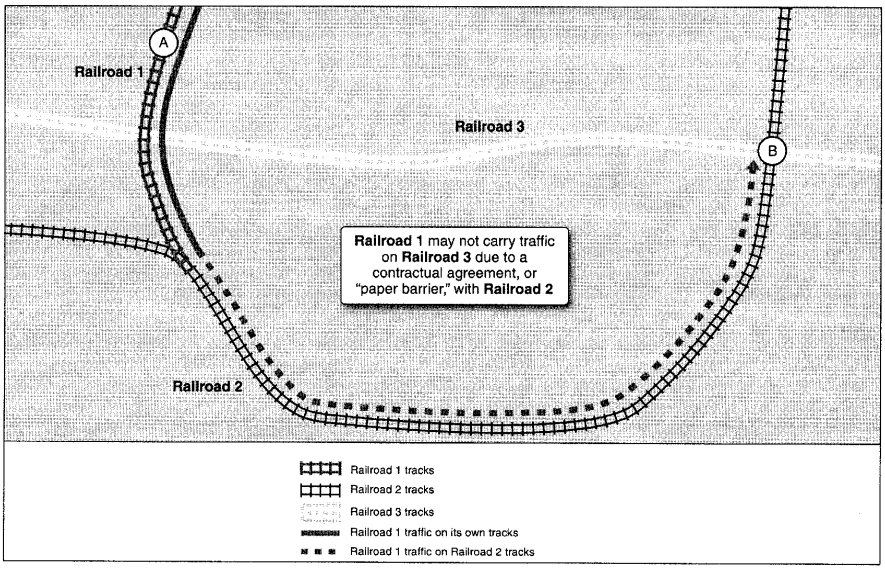
[24] Government Accountability Office Report to Congressional Requesters, "Freight Railroads Industry Health Has Improved, but Concerns about Competition and Capacity Should Be Addressed," October 2006, pp. 50-51. Also see John Frittelli, "Railroad Access and Competition Issues," CRS Report for Congress, Order Code RL34117, updated January 10, 2008, pp. 7-8:

> Typically, when a Class I railroad sells or leases a track segment to a short-line railroad, the Class I railroad offers a much lower price (maybe lower rent or no rent) if the short-line agrees to interchange all of the existing traffic on the line with the selling railroad. These selling arrangements are referred to as "paper barriers." Under these arrangements, the main line railroad can ensure that it will maintain the traffic (and the freight revenues) that the feeder line generated on its main line network. It is also purportedly the case that potential short-line operators simply do not have the finances necessary to buy the line outright at fair market value, so the selling railroad uses an interchange commitment to recover the line's fair market value. New traffic that the short-line is able to generate after the sale, either by finding new customers or additional cargo from existing customers that previously moved by non-rail modes, may not be subject to this interline restriction.

FIGURE 21-5
GAO INTERCHANGE COMMITMENT ILLUSTRATION[25]



Source: GAO.

There is some disagreement between shippers and railroads (particularly Class II and III railroads) regarding the elimination of interchange commitments:

> Captive shippers support eliminating paper barriers because they view it as a means for increasing rail-to-rail competition. They further argue that in an era of tight rail capacity, where certain segments are prone to delays, it is simply bad public policy to not allow shippers to utilize all potential routing options.
>
> Short-line railroads contend that banning paper barriers would negatively affect their potential customers because it would discourage Class I railroads from selling the lines in question for fear of losing freight revenue to a competing main line railroad. Because Class I railroads typically view the line in question as less profitable, they are reluctant to reinvest in the line, leaving those customers located on the line with inferior rail service. Short-lines argue that these rail customers could receive much better service if the line was under their management. Most agree that short-line railroads

[25] Government Accountability Office Report to Congressional Requesters, "Freight Railroads Industry Health Has Improved, but Concerns about Competition and Capacity Should Be Addressed," October 2006, p. 51, Figure 25.

> have a good track record for improving service because their customers are central to the viability of their enterprise, rather than being marginal contributors.[26]

The Railroad Competition and Service Improvement Act of 2007 contains provisions relating to interchange commitments. According to the Congressional Research Service's summary, S. 953:

> would disallow interchange commitments between a Class I railroad and a Class II or III railroad as part of a rail line sale and it would disallow charging higher per car interchange rates for Class II or III railroads to interchange traffic with a railroad other than the selling railroad.[27]

Specifically, Section 103 of S. 953 amends Section 10901 of Title 49, United States Code to add the following:

> (e)(1) The Board may not issue a certificate authorizing an activity described in subsection (a), section 10902, or section 11323, or exempt a person, a class of persons, a transaction, or a service from the applicability of this section with respect to such an activity under section 10502, if the activity involves a transfer of interest in a line of railroad, from a Class I rail carrier to a Class II or Class III rail carrier, and the activity would directly or indirectly—
> (A) restrict or limit the ability of the Class II or Class III rail carrier to interchange traffic with other rail carriers;
> (B) restrict or limit competition of rail carriers in the region affected by the activity in a manner that would violate antitrust laws of the United States (notwithstanding any exemption from the applicability of antitrust laws that is provided under section 10706 or any other provision of law); or
> (C) require higher per car interchange rates for Class II or Class III rail carriers to interchange traffic with other rail carriers.
> (2) Any party to an activity described in paragraph (1) that has been carried out, or any rail shipper affected by such an activity, may request that the Board review the activity to determine whether the activity has resulted in a restriction described in that paragraph. If the Board determines, upon review of the activity, that the activity resulted in such a restriction, the Board shall

[26] John Frittelli, "Railroad Access and Competition Issues," CRS Report for Congress, Order Code RL34117, updated January 10, 2008, p. 8.

[27] John Frittelli, "Railroad Access and Competition Issues," CRS Report for Congress, Order Code RL34117, updated January 10, 2008, p. 8.

> declare the restriction to be unlawful and terminate the restriction unless the Board determines that the termination of the restriction would materially impair the ability of an affected rail carrier to provide service to the public or would otherwise be inconsistent with the public interest.
> (3) In this subsection, the term 'antitrust laws' has the meaning given that term in subsection (a) of the first section of the Clayton Act (15 U.S.C. 12(a)), except that such term also means section 5 of the Federal Trade Commission Act (15 U.S.C. 45) to the extent that section 5 applies to unfair methods of competition.[28]

In October 2007, the STB issued a decision regarding interchange commitments, concluding that interchange commitments should be judged on a case-by case basis.[29] Under that decision, the STB provided a number of factors to be considered in determining the propriety of interchange commitments and indicated that the most restrictive interchange commitments (total bans on interchange and limitations in perpetuity) would face a higher level of scrutiny.[30] The STB also proposed a number of reporting requirements.

> To facilitate a more informed case-by-case analysis of interchange commitments, we proposed regulations that would (a) require carriers, when seeking Board authorization for sale or lease transactions, to identify any interchange commitment provisions, and (b) provide a procedure whereby shippers or other affected parties may obtain access to such provisions, when participating in authorization proceedings or challenging the continued application of existing interchange commitments.[31]

In May 2008, the STB issued another opinion covering interchange commitments, adding to its previous October 2007 decision. The new opinion requires

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[28] S. 953, 110th Congress, 1st Sess. § 103 (2007).

[29] *Disclosure of Rail Interchange Commitments*, STB Ex Parte No. 575 (Sub-No. 1) (STB served October 30, 2007), p. 1.

[30] *Disclosure of Rail Interchange Commitments*, STB Ex Parte No. 575 (Sub-No. 1) (STB served October 30, 2007), pp. 14-15.

[31] *Disclosure of Rail Interchange Commitments*, STB Ex Parte No. 575 (Sub-No. 1) (STB served May 21, 2008), p. 2.

> parties seeking to obtain an individual exemption for, or to invoke a class exemption covering, a transaction involving the sale or lease of a railroad line identify any provision in their agreements that would restrict the ability of the purchaser or tenant railroad to interchange traffic with a rail carrier other than the seller or landlord railroad. [The] new rules also provide a procedure whereby a shipper or other affected party may obtain access to such provisions.[32]

STB Reforms

The GAO discusses three STB reforms—increased use of simplified guidelines, increased use of arbitration, and development of alternative cost methodology—that have been proposed to improve the STB rate relief process. In this section, we discuss the increased use of arbitration by the STB and the development of an alternative cost method for use in STB rate relief proceedings, both of which have been proposed in recent legislation.

Arbitration. With respect to the increased use of arbitration to resolve disputes between shippers and railroads, the GAO report states:

> Proponents of arbitration argue that the threat of arbitration can induce railroads and shippers to resolve their own problems and limit the need for federal regulation. In addition, the process is quicker and cheaper than the standard rate relief process. For example, Canada offers an arbitration process known as Final Offer Arbitration (FOA), under which both parties submit their best and final offers, and the arbitrator considers the argument from both sides and picks one rate offer from either the railroad or the shipper. FOA is quicker—statutorily, once the process begins it has to be completed within 60 days, or 30 days for disputes involving freight charges less than $750,000, unless the parties agree to a different time frame. In addition, FOA is cheaper—estimates ranged up to $1 million Canadian dollars, for both parties. On the other hand, the decisions are good for only 1 year, so the process could in theory be revisited annually. Critics of this approach suggest that arbitration decisions may not be based on

[32] *Disclosure of Rail Interchange Commitments*, STB Ex Parte No. 575 (Sub-No. 1) (STB served May 21, 2008), p. 1.

> economic principles, such as the revenue and cost structure of the railroad, and arbitrators may not be knowledgeable about the railroad industry. Furthermore, opinions differ significantly about which types of disputes should be covered and what standards (if any) should apply.[33]

Provisions for the arbitration of certain rail rate, service and other disputes involving any agricultural commodity is found in the Railroad Competition and Service Improvement Act of 2007. Specifically, Section 304 of S. 953 would amend Chapter 117 of Title 49, United States Code by inserting the following:

> § 11708. Arbitration of certain rail rate, service, and other disputes
>
> (a) ELECTION OF ARBITRATION.—A dispute described in subsection (b) shall be submitted for resolution by arbitration upon the election of any party to the dispute.
> (b) COVERED DISPUTES.—(1) Except as provided in paragraph (2), subsection (a) shall apply to any dispute between a party and a rail carrier that—
> (A) arises under section 10701(c), 10701(d), 10702, 10704(a)(1), 10707, 10741, 10745, 10746, 11101(a), 11102, 11121, 11122, or 11706;
> (B) involves the transportation of any agricultural product, including timber, paper, and fertilizer; and
> (C) involves—
> (i) the payment of money;
> (ii) a rate or charge imposed by the rail carrier; or
> (iii) transportation or other service by the rail carrier.
> (2) Subsection (a) shall not apply to a dispute if the resolution of the dispute would necessarily involve the promulgation of regulations generally applicable to all rail carriers.
> (c) ARBITRATION PROCEDURES.—Not later than 1 year after the effective date of this section, the Board shall promulgate regulations governing voluntary arbitration that are consistent with the provisions of this section. Such modifications shall include the following:
> (1) Arbitration shall be mandatory if either party elects arbitration in lieu of filing a formal or informal complaint before the Board. Challenges to the reasonableness of rail rates or charges may not be

[33] Government Accountability Office Report to Congressional Requesters, "Freight Railroads Industry Health Has Improved, but Concerns about Competition and Capacity Should Be Addressed," October 2006, pp. 52-53.

subjected to arbitration at the sole election of a rail carrier imposing such rates or charges.

(2) Arbitration shall be before an administrative law judge of the Board, or arranged for by the Board, unless the parties to the arbitration each select an arbitrator and the 2 selected arbitrators agree on a third arbitrator from a list of neutral arbitrators maintained by the Board.

(3) Disputes concerning rates and charges shall not be considered or decided using any method based on stand-alone cost, the costs of a hypothetical competitor, or in reliance on precedent adopting or applying such methods.

(4) Standards for rate reasonableness developed under section 10701(d)(3) shall apply in arbitration under this section. The arbitrator or arbitrators shall adopt the final offer of 1 of the parties, without amendment or compromise, if such position is consistent with this section.

(5) A rate may not be prescribed in an arbitration if such rate would result in a revenue-variable cost percentage below 180 percent or if market dominance is not found. A rate prescription may not remain in effect for longer than 5 years after the date on which the arbitrator's decision becomes final.

(6) If a party to arbitration under this section seeks damages from a rail carrier that do not exceed $500,000 per year based on a claim of excessive rates or charges, the arbitrator shall consider evidence of rates or charges on comparable shipments.

(7) Decisions issued in arbitration under this section shall not be subject to appeal to the Board unless all parties to the arbitration agree to such appeal. Appeals to a court, or to the Board if both parties agree to Board review, shall be based on a clear error standard, and consistency with the requirements of this section.[34]

Alternative Cost Methodology to SAC. With respect to the development of alternatives to the STB's stand-alone cost methodology, the 2006 GAO report states:

> STB could develop an alternative to the cost methodology used under the standard process in which a shipper must demonstrate how much an

[34] S. 953, 110th Congress, 1st Sess. § 304 (2007).

> optimally efficient railroad would need to charge a shipper by constructing a hypothetical, perfectly efficient railroad that would replace its current carrier. For example, STB could use a long-run incremental cost approach to evaluate and decide rate cases. This process, which is used by the Federal Energy Regulatory Commission for regulating rates charged by pipeline companies, bases rates on the actual incremental cost of moving a particular shipment, plus a reasonable rate of return. This approach allows for a quick, standard method for setting prices, but does not take into account the need for differential pricing or the railroad's need to charge higher rates in order to become revenue adequate. Structuring rate regulation around actual costs can also create potential disincentives for the regulated entity to control its costs.[35]

The use of simplified guidelines was discussed at length in Chapter 20. Since (or contemporaneous with) the release of the 2006 GAO report, the STB has implemented modifications to its CMP methodology (October 2006) and the three-benchmark methodology for use in small rate cases (September 2007), and has adopted a simplified SAC methodology for use in medium-sized rate cases (September 2007). As previously discussed in Chapter 20 and its appendix, there has been a successful challenge to a rate's reasonableness under the new three-benchmark methodology, which is currently on appeal.[36]

The Railroad Competition and Service Improvement Act of 2007 contains provisions for an alternative cost methodology to be used by the STB for determining reasonable rates. These provisions would require the STB to change its reasonableness of rate standard. Specifically, Section 302 of S. 953 would amend Section 10701(d) of Title 49, United States Code by adding the following:

> (4)(A) Not later than 1 year after the date of the enactment of this paragraph, the Board shall adopt a method for determining the reasonableness of rail rates based on the railroad's

[35] Government Accountability Office Report to Congressional Requesters, "Freight Railroads Industry Health Has Improved, but Concerns about Competition and Capacity Should Be Addressed," October 2006, p. 53.

[36] *E.I. Dupont de Nemours & Co. v. CSX Transportation, Inc.*, STB Docket No. 42099 (STB served June 30, 2008); *E.I. Dupont de Nemours & Co. v. CSX Transportation, Inc.*, STB Docket No. 42100 (STB served June 30, 2008); *E.I. Dupont de Nemours & Co. v. CSX Transportation, Inc.*, STB Docket No. 42101 (STB served June 30, 2008).

actual costs, including a portion of fixed costs and an adequate return on debt and equity. The method adopted—

(i) shall permit a final determination not later than 9 months after a complaint is filed;

(ii) shall ensure that necessary cost and operational information is available to the complainant;

(iii) shall not require excessive litigation costs; and

(iv) shall require, upon a showing by the shipper of market dominance (as defined in section 10707), that the rail carrier prove that the challenged rate is reasonable.

(B) The Board may not use any method for determining the reasonableness of rail rates based on the costs of a hypothetical competitor, except that, in any rate reasonableness proceeding filed before the method required under subparagraph (A) is adopted, the complaint, upon the election of the complainant, shall be decided based on applicable rate standards in effect on the date of the filing, including small shipper rate guidelines.

(C) The Board shall adopt a method under this paragraph that applies the 'phasing constraint' in its existing rail rate method so that it can be practically administered without substantial litigation-related costs in any proceeding involving a challenge to a rail rate in which the Board determines that the phasing constraint applies.

(5) Upon receiving notification of a challenge made by a shipper to the reasonableness of any rate established by a rail carrier, the Board shall determine the reasonableness of the rate without regard to—

(A) whether the rate is for part of a movement between a point of origin and a destination;

(B) whether the shipper has made arrangements for transportation for any other part of that movement; or

(C) any other contract the shipper has with a rail carrier for any part of the rail traffic involved.[37]

The legislation would also change the determination of market dominance to a strictly quantitative test: any rate with a revenue-variable cost ratio 180 percent or greater would indicate market dominance. There would no longer be a qualitative analysis of the state of competition for the subject traffic as discussed in Chapter 20. Section 302 of S. 953 would amend Section 10707(a) of Title 49, United States Code to read:

[37] S. 953, 110th Congress, 1st Sess. § 302 (2007).

> (a) In this section, 'market dominance' exists if a complainant shipper demonstrates that the challenged rate results in a revenue-variable cost percentage for the transportation to which the rate applies that is not less than 180 percent.[38]

21B. ANTITRUST REFORM

Current Antitrust Immunity for Railroads

Generally, antitrust immunity for railroads can be broken down into two categories: transactional and rate.[39] Transactional immunity refers to transactions that have passed STB scrutiny. Transactions—such as rail carrier mergers for example—that have received STB approval are not subject to additional antitrust scrutiny:

> Transactional immunity (immunity for mergers, acquisitions, and related agreements) arose during the 1920s due to increasing concern over the financial health of the railroads and government experience at managing the railroads during World War I. Such experiences led Congress to believe that in order to enhance the financial returns of investors and to promote better service, it was necessary to promote consolidation within the industry with the help of the Interstate Commerce Commission (ICC), the predecessor to the Surface Transportation Board (STB). The ICC adopted a plan that balanced competition against other concerns that were sometimes inconsistent with competition policy.
>
> Congress required that the ICC approve any agreement between railroads, including mergers and acquisitions…. ICC approval of these transactions immunized the transactions from antitrust scrutiny. [40]

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[38] S. 953, 110th Congress, 1st Sess. § 302 (2007).

[39] Darren Bush, Associate Professor of Law, University of Houston Law Center, "The Intersection of Competition Policy and Surface Transportation Regulatory Policy: An Examination of S. 772, The Railroad Antitrust Enforcement Act," testimony before the Subcomm. on Antitrust, Competition and Consumer Rights of the Senate Judiciary Comm., October 3, 2007, p. 4.

[40] Darren Bush, Associate Professor of Law, University of Houston Law Center, "The Intersection of Competition Policy and Surface Transportation Regulatory Policy: An Examination of S. 772, The Railroad Antitrust Enforcement Act," testimony before the Subcomm. on Antitrust, Competition and Consumer Rights of the Senate Judiciary Comm., October 3, 2007, pp. 4-5.

Specifically, transactional immunities are codified in the various current statutes. 49 U.S.C. § 11321 gives express immunity for STB-approved transactions within its exclusive authority under 49 U.S.C. §§ 11323-11325 relating to consolidations or mergers; acquisitions or control; purchases, leases, or contracts to operate property of another carrier; and acquisitions of trackage rights; and under 49 U.S.C. § 11322 relating to pooling arrangements and agreements to divide traffic. 15 U.S.C. § 18 (Section 7 of the Clayton Act) gives STB-approved transactions relating to corporate acquisitions immunity from this section's prohibiting one party's acquisition of another's stock or assets if the effect of such acquisition would be to lessen competition or create a monopoly.

According to the STB, transactional immunity is

> part of a broader set of preemptions in the statute designed to protect the national, public interest in ensuring the free flow of interstate commerce by preventing parties that do not want to see an increased rail presence in their communities from blocking or delaying those transactions with hundreds of individual suits in every local jurisdiction affected by the transaction.[41]

Rail carrier rate immunity refers to the inability of a shipper to challenge a rate in court.

> In 1995 Congress repealed the provisions that give the ICC authority to review and remedy predatory rates…[and] deregulated traffic moving between shippers and rail carriers under private contract. The ICC and STB have also moved to exempt many rates or other activities from regulation under the Staggers Rail Act of 1980. The effect of an order from the STB stating that certain conduct is no longer subject to regulation is to open that conduct to antitrust attack. However, because the STB has the option of reregulating the conduct, courts have appeared

[41] Charles D. Nottingham, Chairman of the Surface Transportation Board, "An Examination of S. 772, the Railroad Antitrust Enforcement Act," testimony before the Subcomm. on Antitrust, Competition and Consumer Rights of the Senate Judiciary Comm., October 3, 2007, p. 5.

> reluctant to allow plaintiffs to challenge exempted conduct.[42]

Current rate immunities are codified at 49 U.S.C. Section 10706. This statute gives specific immunity to STB-approved rate-related agreements "(including charges between rail carriers and compensation paid or received for the use of facilities and equipment), classifications, divisions, or rules related to them, or procedures for joint consideration, initiation, publication, or establishment of them..."[43] As discussed above in Chapter 20 and its appendix, the STB has noted that there are only a very few Section 10706 agreements currently in place.

Other statutory immunities applicable to rail carriers include:

- 15 U.S.C. § 26, giving railroads immunity from injunctive relief in private civil litigation.
- 15 U.S.C. § 45 from The Federal Trade Commission Act, giving immunity to railroads from FTC enforcement of prohibitions on using unfair methods of competition and unfair or deceptive acts affecting commerce.

In addition, there is a judicially created (as compared to statutory) immunity from treble damages on antitrust rate cases. "Created by the courts in 1922, the doctrine is premised on the idea that tariffs filed with the ICC should be immune from challenge, except before the agency."[44]

Suggested Effects of Antitrust Immunity

Antitrust immunity for railroads has come under scrutiny recently. This stems from what some critics believe are the consequences of that immunity, including:

- *Railroad consolidations*. One claimed effect of the exemption is consolidation in railroad providers. Whereas in 1979 there were 42

[42] Darren Bush, Associate Professor of Law, University of Houston Law Center, "The Intersection of Competition Policy and Surface Transportation Regulatory Policy: An Examination of S. 772, The Railroad Antitrust Enforcement Act," testimony before the Subcomm. on Antitrust, Competition and Consumer Rights of the Senate Judiciary Comm., October 3, 2007, p. 7.

[43] 49 U.S.C. § 10706 (a)(2)(A).

[44] Charles D. Nottingham, Chairman of the Surface Transportation Board, "An Examination of S. 772, the Railroad Antitrust Enforcement Act," testimony before the Subcomm. on Antitrust, Competition and Consumer Rights of the Senate Judiciary Comm., October 3, 2007, p. 6.

Class I Railroads, today there are four that provide over 90 percent of the nation's freight rail transportation.[45]

- *Captive Shippers/Refusal to Provide Rates on Bottleneck Segments.* Captive shippers—shippers who do not have any choice in rail carriers—are a claimed result of railroad consolidations noted above.[46] In addition, as previously reported, rail carriers have refused (with STB affirmation) to provide their captive customers with "rates to points where the rail customer can gain access to a competing railroad."[47]
- *"Paper barriers" or "tie-in agreements."* As discussed above, paper barriers or tie-in agreements refer to certain clauses included in sales agreements or leases between Class I and smaller railroads whereby the smaller rail carrier is restricted from transacting business for the line with other major rail carriers. The leases allow the smaller railroads to operate tracks owned by the larger Class I rail carrier. "The ICC, and later the STB, was given authority to approve such transfers of operating rights in 49 U.S.C. Section 10902."[48] Sometimes these agreements limiting the smaller railroads from transacting business with other, larger rail carriers had time limits, while others were permanent. "The ICC historically approved such restraints, finding that they had no anticompetitive effect."[49]

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[45] The Honorable Herb Kohl, Unites States Senator, Wisconsin, "An Examination of S. 772, the Railroad Antitrust Enforcement Act," Statement before the Subcomm. on Antitrust, Competition and Consumer Rights of the Senate Judiciary Comm., October 3, 2007, p. 1.

[46] The Honorable Herb Kohl, Unites States Senator, Wisconsin, "An Examination of S. 772, the Railroad Antitrust Enforcement Act," Statement before the Subcomm. on Antitrust, Competition and Consumer Rights of the Senate Judiciary Comm., October 3, 2007, p. 2.

[47] Robert Szabo, Executive Director and Counsel, CURE, "An Examination of S. 772, the Railroad Antitrust Enforcement Act," testimony before the Subcomm. on Antitrust, Competition and Consumer Rights of the Senate Judiciary Comm., October 3, 2007, p.5.

[48] Robert Szabo, Executive Director and Counsel, CURE, "An Examination of S. 772, the Railroad Antitrust Enforcement Act," testimony before the Subcomm. on Antitrust, Competition and Consumer Rights of the Senate Judiciary Comm., October 3, 2007, p. 4.

[49] Darren Bush, Associate Professor of Law, University of Houston Law Center, "The Intersection of Competition Policy and Surface Transportation Regulatory Policy: An Examination of S. 772, The Railroad Antitrust Enforcement Act," testimony before the Subcomm. on Antitrust, Competition and Consumer Rights of the Senate Judiciary Comm., October 3, 2007, p. 6.

The Railroad Antitrust Enforcement Act (S. 772, H.R. 1650)

Currently there is legislation in both the Senate and the House to repeal the antitrust exemptions for the railroad industry. The Senate Bill 772 and the House Bill 1650 were substantially similar as introduced, but both bills were changed in committee. For the purposes of this analysis, the current version of S. 772 is discussed here.

Section 2 of S. 772 would amend the proviso of Section 16 of the Clayton Act, codified at 15 U.S.C. § 26, ending rail carrier immunity from injunctive relief in private civil litigation. Section 3 of S. 772 would amend Section 7 of the Clayton Act, codified at 15 U.S.C. § 18, making railroad agreements, mergers, and acquisitions approved by the STB pursuant to 49 U.S.C. § 11321 subject to antitrust scrutiny under Section 7 prohibiting any such transaction if "the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly."[50] Under the proposed Section 4 of S. 772, district courts would not be required to defer to the STB's primary jurisdiction in civil antitrust violation litigations of Sections 4 (Suits by persons injured codified at 15 U.S.C. § 15), 4C (Actions by State attorneys general codified at 15 U.S.C. § 15c), 15 (Restraining violations codified at 15 U.S.C. § 25), or 16 (Injunctive relief for private parties codified at 15 U.S.C. § 26) of the Clayton Act. The proposed Section 5 of S. 772 would amend the portion of Section 11(a) of the Clayton Act, codified at 15 U.S.C. § 21, that vests the enforcement of various provisions of the act with regard to common carriers under subtitle IV of Title 49 with the STB. Enforcement of the prohibitions contained in 15 U.S.C. §§ 13 (Discrimination in price, services, or facilities), 14 (Sale, etc., on agreement not to use goods of competitor), 18 (Acquisition by one corporation of stock of another), and 19 (Interlocking directorates and officers) for rail rate agreements under 49 U.S.C. § 10706 and for rail combinations under 49 U.S.C. § 11321 would no longer be vested in the STB. In addition, under Section 5 of S. 772, the Federal Trade Commission would be responsible for preventing railroads from "using unfair methods of competition in or affecting commerce and unfair or deceptive acts or practices in or affecting commerce."[51] Under the proposed Section 6 of S. 772, 15 U.S.C. § 15 would be amended to add a paragraph specifying that railroads would be subject to treble damages for civil antitrust violation suits.[52] Under the proposed Section 7 of S. 772, the antitrust exemption for STB-sanctioned

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[50] 15 U.S.C. § 18 and S. 772, 110th Congress, 1st Sess. § 3 (2007). Under the original bill, S. 772 would also have made rate agreements between rail carriers under 49 U.S.C. § 10706 subject to antitrust scrutiny. This portion has been struck out by the current version reported by the Senate.

[51] 15 U.S.C. § 45 (a)(2) and S. 772, 110th Congress, 1st Sess. § 5(b) (2007).

[52] 15 U.S.C. § 15 (a) and S. 772, 110th Congress, 1st Sess. § 6 (2007). This proposed change is not included in the House version of the bill.

agreements under 49 U.S.C. § 10706 (i.e., rate agreements) between two or more railroads would no longer exist. In conducting an antitrust analysis under § 10706, the legislation would require the Board to "take into account, among any other considerations, the impact of the proposed agreement on shippers, on consumers, and on affected communities."[53] In addition, proposed Section 7 would limit the STB's exclusive authority for approval of combinations (specifically excluding Clayton Act antitrust scrutiny from the STB's exclusive authority) and removes any antitrust exemption (under the Sherman Act, Clayton Act, FTC Act, or Wilson Tariff Act) from any merger/acquisition transaction. Again, the legislation would require the Board to "take into account, among any other considerations, the impact of the transaction on shippers and on affected communities."[54] It is notable that with regard to combinations under § 11321, the STB antitrust analysis is not required to take into account the effect of the transaction on consumers, in contrast with the antitrust impact analysis for rate agreements under § 10706 where the STB must consider consumers in addition to shippers and affected communities.

Committee Hearings

During the October 3, 2007, hearings on S. 772 before the Senate Judiciary Committee, various interested parties offered the follow arguments for and against the elimination of the antitrust exemptions.

Arguments in favor of eliminating antitrust exemptions:

- There is no good reason for the exemption.[55]
- Other regulated industries—despite being regulated—are still subject to antitrust law.[56]
- Railroad has been substantially deregulated—particularly rate setting—and therefore antitrust enforcement is a necessary check on railroads.[57]

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[53] S. 772, 110th Congress, 1st Sess. § 7 (a) (2007).

[54] S. 772, 110th Congress, 1st Sess. § 7 (b) (2007).

[55] The Honorable Herb Kohl, Unites States Senator, Wisconsin, "An Examination of S. 772, the Railroad Antitrust Enforcement Act," Statement before the Subcomm. on Antitrust, Competition and Consumer Rights of the Senate Judiciary Comm., October 3, 2007, p. 1.

[56] Robert Szabo, Executive Director and Counsel, CURE, "An Examination of S. 772, the Railroad Antitrust Enforcement Act," testimony before the Subcomm. on Antitrust, Competition and Consumer Rights of the Senate Judiciary Comm., October 3, 2007, p. 9. See also, The Honorable Herb Kohl, Unites States Senator, Wisconsin, "An Examination of S. 772, the Railroad Antitrust Enforcement Act," Statement before the United States Senate Committee on the Judiciary, October 3, 2007, p. 1.

- There is a lack of competition in rail providers.[58]
- Captive shippers are facing increased prices and/or declining service.[59]

Arguments against eliminating antitrust exemptions:

- Railroads are already subject to some federal antitrust laws.[60]
- It would create a difficult regulatory environment because customers would have private civil injunctive relief.[61]
- It could lead to dual enforcement concerns with regard to mergers.[62]

21C. INVESTMENT TAX CREDIT

The proposed Freight Rail Infrastructure Capacity Expansion Act of 2007 (S. 1125, H.R. 2116) would amend the IRS Code of 1986 to provide investment incentives for freight rail capacity expansion and "enhance modal tax equity." The Senate bill was sponsored by Senator

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[57] Darren Bush, Associate Professor of Law, University of Houston Law Center, "The Intersection of Competition Policy and Surface Transportation Regulatory Policy: An Examination of S. 772, The Railroad Antitrust Enforcement Act," testimony before the Subcomm. on Antitrust, Competition and Consumer Rights of the Senate Judiciary Comm., October 3, 2007, p. 5.

[58] The Honorable Herb Kohl, Unites States Senator, Wisconsin, "An Examination of S. 772, the Railroad Antitrust Enforcement Act," Statement before the Subcomm. on Antitrust, Competition and Consumer Rights of the Senate Judiciary Comm., October 3, 2007, p. 1.

[59] The Honorable Herb Kohl, Unites States Senator, Wisconsin, "An Examination of S. 772, the Railroad Antitrust Enforcement Act," Statement before the Subcomm. on Antitrust, Competition and Consumer Rights of the Senate Judiciary Comm., October 3, 2007, p. 2.

[60] Charles D. Nottingham, Chairman of the Surface Transportation Board, "An Examination of S. 772, the Railroad Antitrust Enforcement Act," testimony before the Subcomm. on Antitrust, Competition and Consumer Rights of the Senate Judiciary Comm., October 3, 2007, pp. 3-4. See also Paul Moates, on Behalf of the Association of American Railroads, "An Examination of S. 772, The Railroad Antitrust Enforcement Act," testimony before the Subcomm. on Antitrust, Competition and Consumer Rights of the Senate Judiciary Comm., October 3, 2007, pp. 3-4.

[61] Charles D. Nottingham, Chairman of the Surface Transportation Board, "An Examination of S. 772, the Railroad Antitrust Enforcement Act," testimony before the Subcomm. on Antitrust, Competition and Consumer Rights of the Senate Judiciary Comm., October 3, 2007, pp. 5-6.

[62] Charles D. Nottingham, Chairman of the Surface Transportation Board, "An Examination of S. 772, the Railroad Antitrust Enforcement Act," testimony before the Subcomm. on Antitrust, Competition and Consumer Rights of the Senate Judiciary Comm., October 3, 2007, pp. 15-18.

Trent Lott of Mississippi and the House bill is sponsored by Representative Kendrick Meek of Florida. The Senate and House bills are substantially similar. These bills are also similar to the previously proposed Freight Rail Infrastructure Capacity Expansion Act of 2006, also sponsored by Senator Lott.[63]

These bills do not change any existing statute. Rather, this act would add a section to the IRS Code of 1986 whereby a tax credit is provided for 25% of the cost of new, qualified freight rail infrastructure property and new, qualified locomotive property put into service in the tax year. The 2007 bills propose termination of these investment incentives after 2012.[64] These bills provide rules regarding qualified infrastructure property as well as rules regarding qualified locomotive property.

Rail infrastructure property that qualifies for the tax credit includes facilities, track and ways, operating equipment, and certain other property, provided that "the cost… is chargeable to capital account."[65] The bills specify that qualified infrastructure excludes "property which is replacing existing property" at the same location.[66] However, expenditures on "replacement or expansion of a bridge or tunnel to allow for additional clearance, track, or other capacity enhancement where such clearance, track, or other capacity enhancement did not previously exist" would qualify for the tax credit.[67]

The cost of locomotive property may qualify for the tax credit if the purchased property is new, meets EPA emissions standards, and results in a net increase in "the total horsepower of all locomotives owned by, or leased to, the taxpayer" in the tax year.[68] The tax credit is subject to recapture with respect to qualified locomotive property if that property is "sold or otherwise disposed of by the taxpayer" within five years of putting the property into service, unless the property is leased back to the taxpayer after sale.[69]

Specifically excluded from the tax credit are land, rolling stock (with the exception of qualified locomotive property), and certain property predominantly outside the U.S. The bills also include a provision for taxpayers to elect to expense the cost of qualified freight rail infrastructure property (i.e., deduct all costs in the current tax year) not chargeable to a capital account.

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[63] This bill did not become law. S. 3742, 109th Congress, 2nd Sess. (2006).

[64] S.1125, 110th Congress, 1st Sess. (2007).

[65] S.1125, 110th Congress, 1st Sess. § 2 (a) (2007).

[66] S.1125, 110th Congress, 1st Sess. § 2 (a) (2007).

[67] S.1125, 110th Congress, 1st Sess. § 2 (a) (2007).

[68] S.1125, 110th Congress, 1st Sess. § 2 (a) (2007).

[69] S.1125, 110th Congress, 1st Sess. § 2 (a) (2007).

Senate and House committee hearings have not yet been held regarding these bills. However, some industry groups have publicized their support for these bills, and certain entities commented on the proposed investment tax credit at the STB Hearing on Rail Capacity and Infrastructure Requirements held in April 2007.[70] At this hearing, respondents acknowledged the need for increased investment in freight rail infrastructure. Multiple respondents viewed the proposed investment tax credit as a way to, as one respondent phrased it, "bridge the funding gap" between the level of investment necessary to meet growing demand for freight rail and the level of investment rail carriers are currently able to commit to infrastructure expansion.[71] However, some respondents stated that such a tax credit should be coupled with increased oversight of the rail industry and infrastructure investment in particular.[72] Many respondents noted public benefits from the use of rail for freight transportation and some cited such benefits as justification for the proposed tax credit.[73]

21D. Summary of Stakeholder Feedback on Policy Proposals

As discussed in Chapter 5, a number of stakeholders that provided input to us in the qualitative phase of this project expressed opinions about proposed railroad industry legislation and/or STB reforms. We reproduce a summary of that input here.

Legislative Proposals

There was mixed support among shippers for the various bills pending before Congress. A number of respondents who supported legislative reforms stated that they believed Canadian rail regulation would work in the U.S. For example, some shippers believe that final-offer arbitration and zone switching (i.e., reciprocal switching) would improve competitiveness. In support of zone switching, some shippers noted that where reciprocal switching exists in the U.S, they benefit from

[70] This hearing predated the current bills (S. 1125, H.R. 2116), but respondents discussed the 2006 version of the proposed tax credit (S. 3742 of the 109th Congress).

[71] See, for example, Edward R. Hamberger, President and CEO of the Association of American Railroads, comments before the Surface Transportation Board, *Rail Capacity and Infrastructure Requirements*, STB Ex Parte No. 671, April 4, 2007, p. 31.

[72] See, for example, National Grain and Feed Association Comments before the Surface Transportation Board, STB Ex Parte No. 671, *Rail Capacity and Infrastructure Requirements*, April 4, 2007, p. 5.

[73] See, for example, Norfolk Southern Railway Company Statements before the Surface Transportation Board, STB Ex Parte No. 671, *Rail Capacity and Infrastructure Requirements*, April 4, 2007, pp. 15-16.

greater competitive options. Other shippers supported reciprocal switching and bottleneck rates as ways of increasing competition.

While many respondents did not believe that the proposal to remove antitrust exemptions would produce any benefits, others believed that the removal of the exemptions is needed to make the industry more competitive. Those supporting the removal of the antitrust exemptions also thought it is important for the DOJ to have oversight powers in the event of future merger proposals.

Railroads, some shippers, and financial analysts expressed the opinion that the proposed legislative reforms would result in less investment and, thus, exacerbate capacity problems. A few consultants and academics also expressed the view that many of the issues, which the proposed legislative reforms are attempting to resolve, are not effectively addressed because true solutions require a comprehensive, multi-modal view of transportation issues; the issues and solutions are bigger than just rail. Finally, as noted above, there is disagreement on whether more needs to be done on the paper barrier issue.

STB Reforms

An opinion expressed by a number of respondents is that the various legislative reforms are not necessary and that the focus should be on making the STB work better. These respondents hold the opinion that, overall, the current system is working well and that the real need is for more effective protections for those shippers who do not have competitive alternatives. However, other respondents expressed the view that the STB has created a situation where legislative reform is necessary—e.g., “by giving the railroads an unregulated monopoly, the STB has made certain that the only way the situation can be made tolerable is through legislation by Congress.”

One of the major criticisms of the STB’s procedures focuses on the SAC process, which is viewed as expensive, time-consuming and one-sided. In addition, a number of shippers commented that changes in the STB’s procedures made the SAC process a moving target that added expense and time to the process. In this regard, most shippers who have access to the large rate case process said they would not use it. Some shippers, who believe that the SAC process is one-sided in favor or railroads, reported that railroads use this process in their rate negotiations as leverage. Other comments relating to the STB include the definition of “effective competition” (based on access to more than one railroad) prohibits STB oversight in cases where railroads are not behaving competitively. Closely related to this point, imposing trackage rights as a condition of merger in “2:1” situations has not successfully resolved anticompetitive situations.

CONCLUSION

There are a number of proposed policy changes for reforming railroad regulation currently under consideration through proposed legislation. These policy changes include requiring rail carriers to provide rates and routes for bottleneck segments, reciprocal switching, and terminal agreements. Another proposed change would prescribe interchange commitments in track sale/lease agreements. Legislation has also been introduced in both Houses of Congress proposing to end antitrust immunity for STB-approved rates and combinations. Finally, legislation designed to increase investment in rail infrastructure has also been proposed. The GAO has described many of these policy changes as well as the potential benefits and costs associated with each.

In the next chapter, we assess the economic impact of these proposed changes. In doing so, our focus is the effects of policy changes on economic efficiency (i.e., price and output effects). Our empirical analysis is based on our quantitative results and the most recent economic literature on railroad policy analysis. Policy changes will likely produce winners and losers—i.e., what are commonly referred to as “distributional effects.” conomic analysis can help inform who will gain and who will lose and by how much, but economic analysis cannot independently offer judgments about the desirability of the distributional impacts caused by policy changes. In this respect, the goal of our study is to produce information on distributional impacts that will be useful in policy debates among relevant stakeholders.

Chapter 22 Contents

CHAPTER 22 ECONOMIC ANALYSIS OF PROPOSED POLICY CHANGES 22-1

INTRODUCTION 22-1
22A. ASSESSMENT OF THE COMPETITIVE STATUS OF THE U.S. RAILROAD INDUSTRY 22-2
22B. ECONOMIC ANALYSIS OF SPECIFIC POLICY PROPOSALS 22-4
Open-Access Proposals 22-4
Interchange Commitments 22-14
STB Reforms 22-17
Repeal Antitrust Exemptions 22-22
Investment Tax Credit 22-25
CONCLUSION 22-26

LIST OF FIGURES

FIGURE 22-1 GAO BOTTLENECK RATE ILLUSTRATION 22-5
FIGURE 22-2 STYLIZED REPRESENTATION OF RELATIVE COSTS OF INTERCHANGE VERSUS END-TO-END MOVEMENTS 22-7

CHAPTER 22
ECONOMIC ANALYSIS OF PROPOSED POLICY CHANGES

INTRODUCTION

Chapter 21 described recently proposed policy changes for the railroad industry that were discussed in the 2006 GAO report and proposed in bills before Congress. These proposals include changes in policy with respect to bottleneck rates, reciprocal switching, terminal agreements, trackage rights, interchange commitments, and also reforms of STB procedures. In addition, Chapter 21 described other recent proposals that reconsider the railroad industry's antitrust exemptions, and legislative initiatives that propose investment tax credits for the railroad industry. In this chapter, we present our economic analysis of these proposed policy changes. The impact of any proposed policy change will depend crucially upon the specifics of the proposed change and especially the actual implementation of the proposal. Thus our analysis focuses on the likely directions of the effects that the proposed changes will have on economic efficiency and the probable distribution of the reform's impacts across groups of stakeholders. Several of the policy proposals lack the specific detail required for quantifying their likely effects.

The primary focus of our economic analysis of the proposed policy changes is their effects on economic efficiency (i.e., price and output effects). Policy changes that move a market toward a more competitive market outcome (i.e., lower prices and/or greater output) improve economic efficiency (social welfare) as price decreases, output increases, and/or service improves. Policy changes most often produce winners and losers. For example, both the STB's RFP for this project and the 2006 GAO report call for an assessment of the effects of proposed policy changes on railroads' financial health and stability, and on railroad private investment incentives as well as the impacts on shippers.[1] In addition, as documented in Chapter 5 of this report, a number of industry stakeholders are concerned about railroad rates they consider to be too high and look to various policy changes to provide

[1] For example, see GAO Report to Congressional Requesters, "Freight Railroads Industry Health Has Improved, but Concerns about Competition and Capacity Should Be Addressed," October 2006, p. 4; Surface Transportation Board, *Report to the U.S. STB on Competition and Related Issues in the U.S. Freight Railroad Industry*, RFP, July 14, 2007, Task 6.

some type of rate relief. Economics can help inform who will gain and who will lose and by how much, but not whether the resulting balance of interests is "good" or "bad."[2]

We base our economic analysis of proposed policy changes on our quantitative results and the most recent economic literature on railroad policy analysis. Based on our analysis in Volume 2 of this study, we first provide an overall assessment of the competitive status of the U.S. railroad industry. This assessment of the industry's structure and performance provides an initial filter for assessing the need for and likely economic effects of the various policy proposals. For example, if the industry is generally competitive, proposals for significant structural changes are likely to produce greater economic costs than economic benefits. In this situation, more beneficial changes are likely to come, for example, from improvements in the STB's oversight processes or location-specific improvements in competitive circumstances. Alternatively, if the industry structure and performance can be generally characterized as tending more toward monopolistic outcomes, more significant structural changes are likely to produce economic benefits in excess of economic costs.

Upon completing this high-level assessment, we turn to the economic analysis of specific proposed policy changes including the likely effects on economic efficiency and the potential distributional effects of the various proposals.

22A. ASSESSMENT OF THE COMPETITIVE STATUS OF THE U.S. RAILROAD INDUSTRY

As a first step in analyzing the effects of proposed policy changes, we provide an assessment of the structure and performance of the U.S. railroad industry. Based on the results of our quantitative analyses and research from the economic literature, we start with an aggregate assessment and then provide evidence at a commodity-specific level. The aggregate assessment is based on the results of our aggregate variable cost function estimation in Chapters 9 and 10, which relied primarily on R-1 data for the Class I railroads. The commodity-

[2] GAO Director JayEtta Hecker's statement to the House Committee on Transportation and Infrastructure describes the potential "distributional impacts" of the proposed policy changes:

> These approaches each have potential costs and benefits. On the one hand, they could expand competitive options, reduce rail rates, and decrease the number of captive shippers as well as reduce the need for both federal regulation and a rate relief process. On the other hand, reductions in rail rates could affect railroad revenues and limit the railroads' ability and potential willingness to invest in their infrastructure. In addition, some markets may not have the level of demand needed to support competition among railroads.

specific analysis is based on our results from Chapters 11 through 15, which relied on Carload Waybill Sample (CWS) data.

Our major conclusions in Chapters 10 and 18 from the results of our aggregate variable cost function analysis are that density and fixed costs make markups over marginal cost necessary for the railroad industry. By definition, the setting of price above marginal cost is the exercise of market power, but exercise does not imply abuse. Our examination of industry costs and revenues leads us to several basic findings. First, the exercise of market power appears to have increased in the freight railroad industry over the last twenty years. The largest increases in market power appear to have occurred in periods when marginal cost was declining. Second, the increased exercise in market power over the last twenty years has been necessary in order to obtain revenue sufficiency. Only in the most recent year of our analysis does industry revenue noticeably exceed industry cost. Third, economies of density and fixed costs are consistently the primary factors driving the markup of marginal cost. Finally, the recent substantial increase in revenue per ton-mile appears to be largely the result of increases in variable, fixed, and marginal costs—related to increases in railroad industry input prices and diminishing productivity growth—and not due to the increased exercise of market power.

As discussed in Chapter 18, economies of density and fixed costs require that rail rates be marked up over marginal cost. Consistent with the principle of differential pricing, the markups over marginal cost vary across commodity group. Economic efficiency suggests the differential pricing be reflective of the elasticity of demand (i.e., Ramsey pricing).

The overall assessment is that the industry generally has not used its pricing power to achieve excess profits. From our analysis of particular commodity groups, we find rates generally tend to be lower when there is increased competition from other railroads. We also find that rail rates tend to be lower for shipping near water transportation alternatives. While “fairness” remains an issue, this pattern of markups appears generally consistent with economic efficiency pricing.

Railroads can be expected to exercise local market power where possible, though this practice may be moderated by regulatory attention if not direct intervention. That is, railroads may voluntarily cede some market power to avoid regulatory scrutiny. However, in both our qualitative and quantitative research, we did find continuing concerns and issues with respect to captive shippers. For example, some farm products have been a long-standing focus of attention on “captive shipper” issues.

With respect to capacity, we concluded that congestion at various points or corridors in railroad networks appears to be the major culprit in capacity-related performance issues over the last ten years. We also

concluded that one must treat forecasts of future capacity needs as tentative, at best, particularly given the current economic climate in the U.S.

22B. ECONOMIC ANALYSIS OF SPECIFIC POLICY PROPOSALS

The potential policy changes discussed in the 2006 GAO report include changes in railroad policies regarding: bottleneck rates, reciprocal switching, terminal agreements, trackage rights, interchange commitments (paper barriers), and changes in the STB's procedures. Except for changes relating to trackage rights, all of these potential policy changes were contained in recent legislative proposals. In Chapter 21, we described the policy change proposals found in the GAO report and in recently introduced bills before Congress—in particular S. 953 and H.R. 2125, The Railroad Competition and Service Improvement Act of 2007. We described other recently proposed bills in Chapter 21 that reconsider the railroad industry's antitrust exemptions (S. 772, H.R. 1650) as well as bills that propose investment tax credits for the railroad industry (S. 1125, H.R. 2116). We also described proposed reforms to the STB's procedures mentioned in the GAO report, including the increased use of arbitration in STB proceedings and the development of alternative cost methodologies to the STB's SAC methodology.[3]

Open-Access Proposals

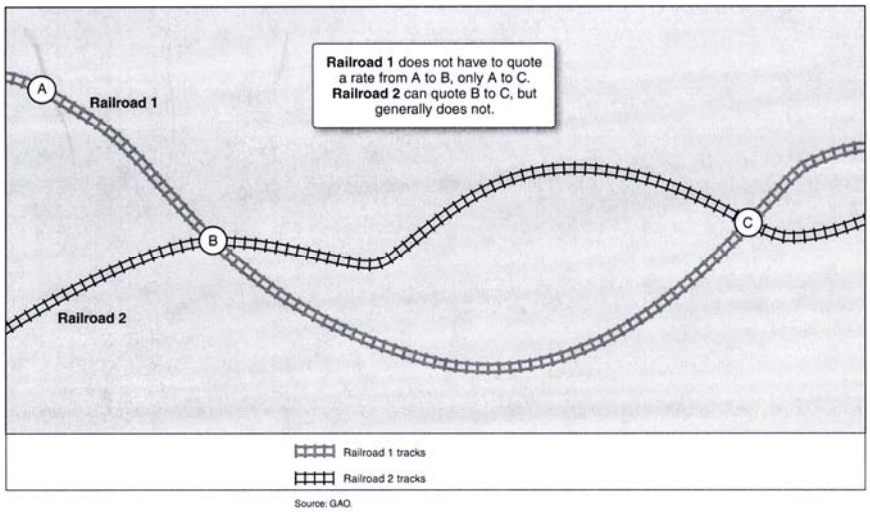
Economic Characteristics of Access Reforms

Several of the policy proposals we review seek to relieve "captive shipper" issues by mandating forms of "open access" to railroad facilities in situations where grants of access currently are voluntary. These proposals would require a railroad to provide access between any two points on its network, including rates for any bottleneck segments on a route ("bottleneck rates"), reciprocal switching agreements, terminal access agreements, and trackage rights. Bottleneck rates and reciprocal switching may be understood as special cases of mandatory interchange arrangements, whereas terminal access and trackage rights are forms of unbundled network access.

To illustrate, we again recreate the diagram of bottleneck rates from the 2006 GAO report as Figure 22-1.

[3] In Chapter 21, we discussed the STB's simplified cost methods that have recently been implemented.

FIGURE 22-1
GAO BOTTLENECK RATE ILLUSTRATION[4]



While this figure was meant to illustrate the concept of bottleneck rates, it can also be used to illustrate the essence of the various other open-access proposals. All of these access reforms can be considered as situations where Railroad 1 provides end-to-end service between two points on its network, A and C. Railroad 2 also serves point C with its network but not point A; an intermediate point B is a potential point of interchange between the railroads. The route segment A to B is the "bottleneck segment" served only by Railroad 1. As described by the GAO, typically Railroad 1 does not quote a rate from A to B, and Railroad 2 does not normally quote a rate from B to C. Bottleneck rates and reciprocal switching proposals require railroads to quote rates for each route segment upon request (and implicitly to interchange traffic at point B). In both of these situations, each railroad provides service over its own tracks. The major distinction between bottleneck rates and reciprocal switching is that in reciprocal switching, the bottleneck segment has a specified maximum length. Terminal access and trackage rights allow Railroad 2 to provide service between points A and C using Railroad 1's bottleneck facilities for some access price. Terminal access agreements are typically limited by length, whereas general trackage rights conceivably may involve granting Railroad 2 access to any destination on Railroad 1's network. See Chapter 21 for additional discussion.

[4] Government Accountability Office Report to Congressional Requesters, "Freight Railroads Industry Health Has Improved, but Concerns about Competition and Capacity Should Be Addressed," October 2006, p. 50, Figure 24.

Economic Effects of Open-Access Reforms on Shipment Costs—Stylized Facts

The costs of the competing services provided by Railroad 2 vary according to the access regime. Under mandatory interchange, Railroad 2's competing service consists of movements from A to B and B to C along Railroad 1's track and Railroad 2's track, respectively. The interchange service will tend to be more costly than Railroad 1's end-to-end service between points A and C. This is because the interchange of traffic is itself costly, and additionally railroad costs per ton-mile generally decline with length-of-haul, so that hauling over sub-segments of the end-to-end movement will be more costly. If Railroad 1 and Railroad 2 are equally efficient, then:

$$(22.1)\quad RRCost_{AB} + RRCost_{BC} + (InterchangeCost) > RRCost_{AC}$$

where $RRCost_{XY}$ is the railroad cost for a movement between points X and Y (e.g., A to B, B to C, etc.).

We can represent the cost of a movement between any two points X and Y relative to the cost of the end-to-end movement between points A and C:

$$(22.2)\quad RRCost_{XY} = LOH_{XY}[(1 + \ln(LOH_{XY} / LOH_{AC}) \cdot \varepsilon_{MC,LOH}) \cdot MC_{AC}$$

where LOH_{XY} is the length of haul between points X and Y, $\varepsilon_{MC,LOH}$ is the elasticity of marginal cost with respect to length of haul (with a negative sign), and MC_{AC} is the marginal cost per ton-mile for the end-to-end shipment between points A and C. The term in brackets is the marginal cost for the XY shipment leg (MC_{XY}). Note that MC_{XY} will be greater than MC_{AC} provided the XY length of haul is shorter than the end-to end haul.[5]

If the interchange shipment's total length of haul is the same as that of the A to C shipment on Railroad 1, then the ratio:

$$(22.3)\quad (RRCost_{AB} + RRCost_{BC}) / RRCost_{AC}$$

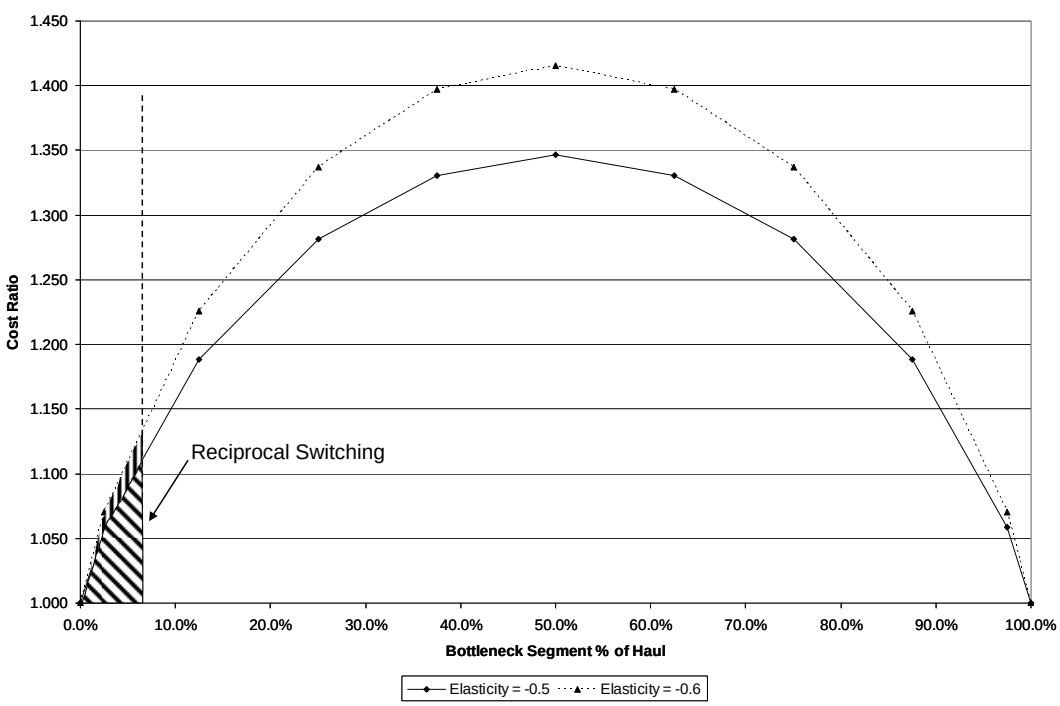
reaches a maximum at $LOH_{AB} = LOH_{BC} = LOH_{AC/2}$, and the maximum cost ratio increases with the absolute value of the elasticity of marginal cost with respect to length of haul. The interchange shipment has the least favorable cost characteristics when the shipment is broken up into two hauls of equal length, which is the worst case for length-of-haul

[5] We assume for the moment that the interchange and end-to-end hauls have the same total length, though of course one or the other railroad will actually have a shorter or otherwise more efficient route between points B and C.

economies. Larger (absolute) values of the elasticity of marginal cost with respect to length of haul increase the piecewise marginal costs.

Length-of-haul economies are illustrated in Figure 22-2. The stylized facts represented in Figure 22-2 illustrate the relatively small loss in economic efficiency from implementing reciprocal switching agreements versus more expensive bottleneck rate proposals. This figure shows how equation (22.3) varies with the bottleneck segment's length (as a fraction of the total haul), assuming marginal cost of 1.5 cents/ton-mile, length-of-haul elasticities of -0.5 and -0.6, total length of haul of 800 miles, and no interchange cost. For short bottleneck segments, the relative costs of the A to C and interchange shipments are relatively close. For a 20-mile bottleneck segment (2.5 percent of the hypothetical haul), the interchange shipment is 5.8 to 7 percent more costly than the A to C shipment on Railroad 1. While the cost per ton-mile on the short segment is high, there is relatively little loss of efficiency for the longer-haul segment. The cost picture becomes less favorable as the length of the bottleneck segment increases. For a 100-mile bottleneck segment, the cost increase is 19 to 23 percent, and at the maximum the interchange shipment is 35 to 42 percent more costly. For longer bottleneck segments, merely requiring railroads to quote rates for route segments may not provide much if any relief to captive shippers, to the extent the increased costs outweigh competitive price responses.

FIGURE 22-2
STYLIZED REPRESENTATION OF RELATIVE COSTS OF INTERCHANGE VERSUS END-TO-END MOVEMENTS



Terminal access and other trackage rights arrangements lead to additional cost considerations for the competitive shipment via Railroad 2. Since Railroad 2 hauls the shipment over Railroad 1's bottleneck segment under those reforms, either serving railroad enjoys the length-of-haul economies for the end-to-end movement. The additional cost for the access arrangement is the cost of coordinating Railroad 2's access to the bottleneck segment with Railroad 1. Also, as discussed below, the economic literature has found that railroads enjoy economies of vertical integration (e.g., the integration of the maintenance and operation of the physical network with train operations)[6] that would be diminished under various open-access policies.

Of course, Railroad 1 and Railroad 2 are unlikely to be equally efficient in practice. For example, one railroad is likely to have a shorter route between points B and C (the non-bottleneck segment). If the "incumbent" Railroad 1 has the shorter route, then the alternative interchange movement by Railroad 2 will have a worse relative cost position.

Economic Effects of Open-Access Reforms—Evidence from Empirical Results

Our aggregate variable cost function results in Chapter 9 indicate that, although economies of density diminished over the years in our sample frame (1987 to 2006), the Class I railroad industry still experiences economies of density. Thus, from our results, if increasing open access results in an equal amount of aggregate traffic, there will likely be redistribution among railroads as railroads gaining traffic gain economies of density and the railroads losing traffic lose economies of density. For there to be an overall economic welfare gain (either in terms of lower costs due to economies of density or increases in shipper welfare), overall traffic must increase and/or shipper rates must fall—i.e., the open-access proposals must generate a voluntary competitive response by railroads. The likelihood of competitive response is highly dependent on the length-of-haul economies discussed above. In addition, other considerations such as the determination of access charges, the strength and existence of vertical economies, and coordination costs between railroads are important for open-access policies to produce the desired competitive responses.

Bitzan examines railroad cost properties and concludes from his cost function results that multiple-firm operation over a single rail network would lead to cost increases in both the case of open access and

[6] Also discussed below are the issues of determining appropriate access charges and potential investment disincentives of open access policies.

the case where competition is introduced in bottleneck rail segments.[7] He states that the welfare impact of multiple-firm competition over a single rail network depends not only on the cost effects but also whether there are price decreases and increases in output resulting from the competition that are sufficient to offset the cost inefficiencies introduced by multi-firm operation over a single network. Bitzan concludes that:

> [R]ailroads are natural monopolies in providing transport services over their own network, suggesting that multiple-firm competition over such a network would result in increased resource costs. These findings suggest that policies introducing rail competition through "open access" or on bottleneck segments would not be beneficial from a cost perspective. Moreover, the price decreases necessary for the introduction of such competition to be beneficial would be large. Thus, to the extent that rate and service problems exist in the US railroad industry, policies aimed at strengthening rate reasonableness guidelines and service guidelines would be preferred to policies aimed at introducing competition.[8]

Pittman discusses various levels of open access, including structural or vertical separation—i.e., separate operators of rail infrastructure and rail services—and the experiences of a number of countries with various levels of open access. While none of the current policy proposals advocates complete vertical separation of the U.S. railroad industry, a number of proposals advocate some degree of open access—e.g., terminal agreements and trackage rights—or what Pittman terms "vertical access." Reviewing the European experience with vertical access, Pittman notes a number of issues that have prevented such access from achieving the desired results of increased competition and the resulting benefits for consumers, one of which is the efficiency of the vertically integrated firm:

> Most common has been the case that non-integrated train companies have been allowed to enter the

[7] John D. Bitzan, "Railroad Costs and Competition, The Implications of Introducing Competition to Railroad Networks," *Journal of Transportation Economics and Policy*, Vol. 37, Part 2, May 2003, p. 218.

[8] John D. Bitzan, "Railroad Costs and Competition, The Implications of Introducing Competition to Railroad Networks," *Journal of Transportation Economics and Policy*, Vol. 37, Part 2, May 2003, p. 224.

> markets but have been unable to gain much market share against the entrenched incumbents. …
>
> There are a number of reasons for what we may call this (again, thus far) disappointment. The first may be something of a logical fallacy: if the integrated train company enjoys vertical economies—which indeed is apparently the reason for allowing it to remain integrated—then it follows that most non-integrated train operators, not enjoying such economies, will be at a disadvantage to the integrated company in competing for business. …[9]

Pittman also discusses that the setting of appropriate access fees is an issue that is not easily resolvable:

> [T]o the extent that the regulator forces the infrastructure operator to offer access to integrated and non-integrated train users alike at non-discriminatory terms, it may reduce the ability of the infrastructure operator to cover its fixed costs through access fees. Identical, non-discriminatory access fees that cover fixed costs impose what may be a large welfare cost on the economy by denying infrastructure access to those enterprises whose value of use would be below average cost but above marginal cost. The vertical access model remains a work in progress, not an obvious failure but not yet a success, either.[10]

Pittman notes that experiences of other industries or in other countries with various types of open access may not be transferable to the railroad industry:

> What is the problem with vertical separation in the freight railroad sector? The problem is that freight railroads are different from infrastructure sectors where there is more, and more successful experience with vertical separation, in particular electricity, natural gas, and telecommunications. They are different from these other infrastructure

[9] Russell Pittman, "Structural Separation to Create Competition? The Case of Freight Railways," *Review of Network Economics*, 4(3), September 2005, p. 190.

[10] Russell Pittman, "Structural Separation to Create Competition? The Case of Freight Railways," *Review of Network Economics*, Vol. 4, Issue 3, September 2005, p. 190.

> sectors in ways that are likely systematically to make vertical separation a difficult policy to implement. The relatively higher level of sunk and fixed costs in railroads means that difficulties in creating the right incentives for investment impose a heavier costs in railways than elsewhere, and mean that the trade-off in access pricing between short-term efficiency and long-term efficiency (*that is*, both full cost recovery and procompetitive investment) is more stark in railways than elsewhere. The apparently non-vanishing economies of density in train operation mean that even if a given infrastructure grid is opened to entry by competing train operators, that operator that achieves a "first mover" advantage is likely to keep it, and to be able to set and adjust its tariffs in such a way as to prevent the development of significant competition.[11]

In a 2006 review of the state of economic literature on the regulation of infrastructure industries and the implications for investment, Guthrie discusses the uncertain effect on investment incentives of expanding competition in vertically integrated network industries. In particular, he notes that opening up networks to competition typically slows down incumbents' investment in situations where rivals cannot pre-empt the incumbents' investment (the most likely situation in railroads where rivals are not likely to duplicate the network). Moreover, he states that the terms of access to incumbent bottleneck facilities is a crucial influence on investment behavior, but the state of economic understanding of these influences is not fully understood. As an example, Guthrie describes the problems that continue to exist in the telecommunications industry, despite ten years of experience with open-access issues:

> Opening up some segments to competition can have a dramatic impact on the incumbent's investment behavior, typically accelerating investment if rivals can preempt the incumbent's investment and slowing it down if they cannot. Regulating the terms of access to the incumbent's bottleneck facilities can alter this behavior, but more research is needed before the possibilities are fully understood. Although there is an emerging

[11] Russell Pittman, "Structural Separation to Create Competition? The Case of Freight Railways," *Review of Network Economics*, Vol. 4, Issue 3, September 2005, p. 191.

> literature on investment in this new regulatory environment, economists are struggling to keep up with the changes. Almost ten years have passed since the Telecommunications Act transformed telecommunications regulation in the United States and economists still do not have a thorough understanding (theoretically or empirically) of how local loop unbundling affects investment. Understanding of the investment response to electricity transmission pricing is even less developed. More study of access regulation and its impact on investment behavior, especially investment timing, is needed.[12]

Summary of Economic Effects of Open-Access Proposals

For the proposed open-access policies to produce an overall gain in economic welfare, the effects of lower prices to shippers, increased output, and/or increased service quality due to competitive pressures must outweigh any increase in railroad costs. Furthermore, in a dynamic context, the economic assessment of the likely effects of these proposals must include the impacts on railroads' profitability and investment incentives.

Table 22-1 presents a summary of the likely economic effects of the four open-access proposals. The assumption for each of these proposals is that, although these types of open-access arrangements are currently mandated to some degree, the terms of access are allowed to be determined through voluntary negotiations between railroads, with STB oversight of the process. To the extent that the terms of access are set according to some legislative or regulatory formula that results in outcomes that differ from the terms resulting from voluntary negotiations, the economic effects of these open-access proposals becomes less predictable.

[12] Graeme Guthrie, "Regulating Infrastructure: The Impact on Risk and Investment," *Journal of Economic Literature*, 44(4), 2006, pp, 968-969.

TABLE 22-1
LIKELY ECONOMIC EFFECTS OF VARIOUS OPEN-ASSESS PROPOSALS

	Reciprocal Switching	Bottleneck Rates	Terminal Agreements	Trackage Rights
Economies of Density	Potential gains	Gains unlikely	Potential gains	Potential gains
Length-of-Haul Economies	Small loss	Potentially large loss	No gain to small gain	No gain to small gain
Vertical Economies	Small loss	Potentially large loss	Small loss	Potentially large loss
Investment Incentives	Small effect	Potentially large effect	Small effect	Potentially large effect
Railroad Profitability	Small effect	Potentially large effect	Small effect	Potentially large effect
Coordination Costs	Small to moderate	Small to moderate	Small to moderate	Potentially large
Competitive Response	Most likely	Least likely	Most likely	Somewhat likely
Shipper Gains	Most likely	Least likely	Most likely	Somewhat likely

Of the various open-access policies proposed in recent legislation, those policies that propose incremental changes—e.g., reciprocal switching and terminal agreements—will be the least costly in terms of loss of economic efficiency and, in our opinion, the most likely to produce competitive responses by railroads. The losses of economies of density and vertical integration, and a likely negative impact on incumbent investment incentives, are among the economic efficiency costs that must be weighed against any potential gains. Of course, to the extent that competitive responses result and traffic increases, static efficiency losses may be overcome—e.g., there would be a likely gain in economies of density if volumes increase. Some proposals, such as requirements to quote bottleneck rates, may not be workable or effective because the economics of particular situations (e.g., loss of length-of-haul economies) will not produce the anticipated degree of competitive response. Conversely, incremental policies such as reciprocal switching and terminal agreements are most likely to produce an outcome of increased railroad competition as length-of-haul economies are least affected by end-point open access.

Furthermore, as we discussed in Chapter 18, the competitive response of railroads to these proposed policy changes will likely vary by commodity and/or location. In Chapter 18, we observed stronger responses of RPTM (revenue per ton-mile) to railroad competition for coal, chemicals, and transportation equipment than for corn, wheat, soybeans, and intermodal shipments. We concluded that features of

shipment geography (including shipper density) create limitations on the ability to incent railroad competition and also other forms of competition. In such cases, regulatory oversight is required to ensure that shipper captivity, driven by unavoidable limitations of shipment geography, does not result in railroad prices that are determined to be "unreasonable."

Finally, in order to succeed these proposals must address implementation details that will have an important influence on the success or failure of the policy changes. One critical detail is the terms of access, which evoke a very controversial topic in the economic literature. Not only can the terms of access have an effect on the degree to which open access occurs, but they can have important effects on incumbents' investment behavior. None of the current policy proposals address these important details and, therefore, the implementation of any of these policy changes entails the very real risks of unintended and economically harmful outcomes. Our assessment that the railroad industry overall is pricing at levels generating earnings that maintain or slightly exceed those necessary to ensure financial viability implies that there is little room to provide significant "rate relief" to certain groups of shippers without requiring increases in rates for other shippers or threatening railroad financial viability. Thus, distributional effects among shipper groups, as well as between shippers and railroads, are primary considerations. We believe that incremental policies such as reciprocal switching and terminal agreements have a lower potential of leading to adverse changes to industry structure, costs, and operations, and additionally have greater likelihoods of resolving shipper concerns via competitive market responses.

Interchange Commitments

As we described in Chapter 21, the Railroad Competition and Service Improvement Act of 2007 contains provisions that would disallow interchange commitments ("paper barriers") between a Class I railroad and a Class II or III railroad as part of a rail line sale. In addition, this act would disallow charging higher per car interchange rates for Class II or III railroads interchanging traffic with a railroad other than the selling railroad.[13]

The 2006 GAO report discusses potential benefits and costs of interchange commitments:

> When this type of agreement exists, it can inhibit smaller railroads that connect with or cross two or

[13] "Railroad Access and Competition Issues," CRS Report for Congress, Order Code RL34117, January 10, 2008, p. 8; S. 953, 110th Congress, 1st Sess. § 103 (2007).

> more Class I rail systems from providing rail customers access to competitive service. Eliminating paper barriers could affect the railroad industry's overall capacity since Class I railroads may abandon lines instead of selling them to smaller railroads and thereby increase the cost of entering a market for a would-be competitor.[14]

There is some disagreement between shippers and railroads (particularly Class II and III railroads) regarding the elimination of interchange commitments:

> Captive shippers support eliminating paper barriers because they view it as a means for increasing rail-to-rail competition. They further argue that in an era of tight rail capacity, where certain segments are prone to delays, it is simply bad public policy to not allow shippers to utilize all potential routing options.
>
> Short-line railroads contend that banning paper barriers would negatively affect their potential customers because it would discourage Class I railroads from selling the lines in question for fear of losing freight revenue to a competing main line railroad. Because Class I railroads typically view the line in question as less profitable, they are reluctant to reinvest in the line, leaving those customers located on the line with inferior rail service. Short-lines argue that these rail customers could receive much better service if the line was under their management. Most agree that short-line railroads have a good track record for improving service because their customers are central to the viability of their enterprise, rather than being marginal contributors.[15]

As we discussed in Chapter 21, the STB issued a decision in October 2007, regarding interchange commitments in which the Board concluded that interchange commitments should be judged on a case-by-

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[14] Government Accountability Office Report to Congressional Requesters, "Freight Railroads Industry Health Has Improved, but Concerns about Competition and Capacity Should Be Addressed," October 2006, pp. 50-51.

[15] "Railroad Access and Competition Issues," CRS Report for Congress, Order Code RL34117, January 10, 2008, p. 8.

case basis.[16] Additional reporting requirements were enumerated in a subsequent May 2008 STB decision.[17] The decision noted that a case-by-case assessment is appropriate because the assessment of the benefits and costs of these commitments is a fact-specific exercise:

> [W]e conclude that the lawfulness of the terms of interchange commitments is best considered on an individualized, case-by-case basis. Generally, interchange commitments have facilitated the creation and growth of short line railroads, which in turn has benefitted the public by lowering transportation costs, improving service, and in some cases preserving rail transportation to localities and communities that might otherwise have seen service over their lighter-density line deteriorate or be lost altogether.
>
> However, not all situations are the same, nor are all agreements. A particular interchange commitment may be contrary to the public interest because it is unduly restrictive or unwarranted under the circumstances. Therefore, to assess the public interest, we must weigh the benefits of a particular interchange commitment against its potential for harm. The inquiry into whether a particular interchange commitment represents more harm than good is necessarily fact-specific. Therefore, no single rule of general applicability seems appropriate, and we will not attempt to establish such a rule.[18]

Our understanding from our Advisory Panel is that the STB's approach in this matter parallels the "rule of reason" analysis performed under antitrust laws to assess the lawfulness of contractual exclusivity arrangements. Furthermore, an absolute ban on interchange commitments (as contemplated in S. 953) would definitely be more stringent than antitrust laws. A strong restriction that allows justifications would be consistent with the law, although current case law would likely view such a strong restriction as too strict. We

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[16] *Disclosure of Rail Interchange Commitments*, STB Ex Parte No. 575 (Sub-No. 1) (STB served October 30, 2007), p. 1.

[17] *Disclosure of Rail Interchange Commitments*, STB Ex Parte No. 575 (Sub-No. 1) (STB served May 21, 2008), p. 1.

[18] *Disclosure of Rail Interchange Commitments*, STB Ex Parte No. 575 (Sub-No. 1) (STB served October 30, 2007), pp. 7-8.

conclude that the discussion of costs and benefits contained in the GAO and STB analyses is accurate, and that a careful case-by-case analysis of interchange commitments is warranted.

STB Reforms

Arbitration

As described in Chapter 21, provisions for final-offer arbitration of certain rail rate, service, and other disputes involving any agricultural commodity, including timber, paper and fertilizer, are found in the Railroad Competition and Service Improvement Act of 2007.[19]

In our interviews of stakeholders, we found mixed support for the use of arbitration by the STB. Proponents pointed to Canadian final-offer arbitration as a model to follow. Proponents called attention to the lower cost of arbitration versus rate cases, and the incentives to reach a voluntary agreement instead of going to arbitration. However, other stakeholders viewed the final-offer arbitration process as not being based on economic principles but, instead, as a largely political process devoid of guidance from economic principles. Respondents opposed to the use of final-offer arbitration also noted that the process did not establish precedents to guide in the settlement of future disputes because of the confidential nature of arbitration decisions. Those with some experience with Canadian-style arbitration also said that because of the lack of precedents and the use of arbitrators without experience in the complexities of railroad economics, arbitrators had difficulty in coming up with informed decisions. Many of these costs and benefits of arbitration were echoed in the GAO report:

> Proponents of arbitration argue that the threat of arbitration can induce railroads and shippers to resolve their own problems and limit the need for federal regulation. In addition, the process is quicker and cheaper than the standard rate relief process. For example, Canada offers an arbitration process known as Final Offer Arbitration (FOA), under which both parties submit their best and final offers, and the arbitrator considers the argument from both sides and picks one rate offer from either the railroad or the shipper. FOA is quicker—statutorily, once the process begins it has to be completed within 60 days, or 30 days for disputes involving freight charges less than $750,000, unless the parties agree to a different time frame. In

[19] S. 953, 110th Congress, 1st Sess. § 304 (2007).

> addition, FOA is cheaper—estimates ranged up to $1 million Canadian dollars, for both parties. On the other hand, the decisions are good for only 1 year, so the process could in theory be revisited annually. Critics of this approach suggest that arbitration decisions may not be based on economic principles, such as the revenue and cost structure of the railroad, and arbitrators may not be knowledgeable about the railroad industry. Furthermore, opinions differ significantly about which types of disputes should be covered and what standards (if any) should apply.[20]

To the extent that the threat or possibility of final-offer arbitration encourages parties to negotiate and reach voluntary agreements or resolve disputes, as suggested by a number of stakeholders we interviewed, it would improve the functioning of private markets without imposing additional regulatory burdens. However, if matters are not resolved between parties and do go to arbitration, there are real concerns whether the process will produce outcomes consistent with competitive market outcomes. Since the economics of the railroad industry are very complex, with issues of returns to density, revenue adequacy, and differential pricing being of great significance, there is a risk that final-offer arbitration may produce results that are at odds with the economics of the railroad industry. Therefore, it would be appropriate to carefully evaluate any potential policy changes in this direction. In particular, given comments we received from some stakeholders, one major consideration would be the requirement that potential arbitrators have expertise in the railroad industry and its economics.

Simplified Guidelines

The STB's simplified guidelines were discussed in some detail in Chapter 20 and its appendix. Since (or contemporaneous with) the release of the 2006 GAO report, the STB has implemented modifications to its constrained market pricing (CMP) methodology (October 2006) and the three-benchmark methodology for use in small rate cases (September 2007), and has adopted a simplified stand-alone cost (SAC) methodology for use in medium-sized rate cases (September 2007).

As previously discussed in Chapter 20 and its appendix, there has been a successful challenge to a rate's reasonableness under the new

[20] Government Accountability Office Report to Congressional Requesters, "Freight Railroads Industry Health Has Improved, but Concerns about Competition and Capacity Should Be Addressed," October 2006, pp. 52-53.

three-benchmark methodology, but the STB's decision is currently under appeal.[21] In September 2007, the STB modified its simplified guidelines and also created a simplified SAC approach for use in medium-sized disputes challenging the reasonableness of rates.[22] In October 2007, E.I. du Pont de Nemours and Company (DuPont) filed three amended complaints challenging the reasonableness of rates charged by CSX Transportation, Inc. (CSX) for seven freight rail movements.[23] DuPont proceeded under the "three-benchmark method" as described below, using the newly revised simplified guidelines. On June 30, 2008, the STB's decisions were delivered on the three cases, awarding DuPont up to $3 million (the maximum award of up to $1 million for each of the three freight rail complaint cases) and setting a rate prescription for six of the seven challenged movements. CSX has appealed the STB's decision to the U.S. Court of Appeals for the District of Columbia, stating that the rate decision was "an abuse of discretion, and not supported by substantial evidence."[24]

Given that the STB has initiated recent changes to adopt simplified guidelines, it would be appropriate to conduct a review of those changes at some time in the near future, to determine whether they have proved to be practical simplifications that facilitate the regulatory process and whether any further changes would be desirable.

Alternative Cost Methodology to STB's Stand-Alone Cost Methodology

As described in Chapter 21, the Railroad Competition and Service Improvement Act of 2007 contains provisions for an alternative cost methodology for the STB to use in determining the reasonableness of rates. These provisions would require the STB to change its reasonableness of rates standard. Specifically, Section 302 of S. 953 calls for a method for determining rate reasonableness:[25]

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[21] *E.I. Dupont de Nemours & Co. v. CSX Transportation, Inc.*, STB Docket No. 42099 (STB served June 30, 2008); *E.I. Dupont de Nemours & Co. v. CSX Transportation, Inc.*, STB Docket No. 42100 (STB served June 30, 2008); *E.I. Dupont de Nemours & Co. v. CSX Transportation, Inc.*, STB Docket No. 42101 (STB served June 30, 2008).

[22] *Simplified Standards for Rail Rate Cases*, Ex Parte No. 646 (Sub-No. 1) (STB served September 5, 2007), p. 1.

[23] *E.I. Dupont de Nemours & Co. v. CSX Transportation, Inc.*, STB Docket No. 42099 (STB served June 30, 2008); *E.I. Dupont de Nemours & Co. v. CSX Transportation, Inc.*, STB Docket No. 42100 (STB served June 30, 2008); *E.I. Dupont de Nemours & Co. v. CSX Transportation, Inc.*, STB Docket No. 42101 (STB served June 30, 2008).

[24] J. Boyd, *CSX Appeals DuPont Decision*, Traffic World Online, July 17, 2008, http://www.trafficworld.com/newssection/rail.asp?id=47087 (as viewed July 17, 2008).

[25] S. 953, 110th Congress, 1st Sess. § 302 (2007).

- Based on the railroad's actual costs, including a portion of fixed costs and an adequate return on debt and equity; the method cannot be based on the costs of a hypothetical competitor,
- That would have final determination no later than nine months after the filing of a complaint,
- That would not require excessive litigation costs,
- That upon a showing by shipper of market dominance would require that the rail carrier prove the rate is reasonable.

Most analysts would generally agree that the provisions that rate reasonableness be determined within nine months and not require excessive litigation costs are commendable goals, although the meaning of "excessive" litigation costs is ambiguous and likely problematic. However, the requirement that the cost standard be based on the railroad's actual costs, including a portion of fixed costs and an adequate return on debt and equity, presents a number of concerns from an economic viewpoint. This requirement is essentially a prescription for what is known as a fully distributed costing (FDC) method. FDC methods have been criticized and discredited in the regulatory economics literature for at least 25 years.[26] In fact, one of the earliest economic criticisms of FDC methods came in a 1962 statement presenting the consensus of ten economists regarding railroad costs and pricing.[27] Furthermore, because of the inherently arbitrary nature of fixed-cost allocations, FDC pricing is generally not consistent with the differential pricing principles that guide railroad pricing.[28] Therefore, it is our opinion that the cost standards proposed in S. 953 would produce arbitrary results that would likely be at odds with Ramsey pricing principles. Given the arbitrary, unpredictable nature of FDC methods and the unspecified allocation of a "portion of fixed costs" in the proposed legislation, it is unclear whether the implementation of the proposed alternative cost methodology would be to the detriment of shippers, railroads, or both. At the very least, if railroads are revenue

[26] For example, see Alfred E. Kahn, "The Uneasy Marriage of Regulation and Competition," *Telematics*, Vol. 1, 1984, pp. 1-17; Alfred E. Kahn and William B. Shew, "Current Issues in Telecommunications Regulation: Pricing," *Yale Journal on Regulation*, 4, pp. 191-256.

[27] William J. Baumol, Burton N. Behling, James C. Bonbright, Yale Brozen, Joel Dean, Ford K. Edwards, Calvin B. Hoover, Dudley F. Pegrum, Merrill J. Roberts, and Earnest W. Williams, Jr., "The Role of Cost in the Minimum Pricing of Railroad Services," *The Journal of Business*, 36(3), 1962, pp. 348-351.

[28] For example, see Ronald R. Braeutigam, "An Analysis of Fully Distributed Cost Pricing in Regulated Industries," *Bell Journal of Economics*, Vol. 11, 1980, pp. 182-196.

adequate with no excess profits, the implementation of an FDC method would likely result in a shift of the fixed-cost burden among shipper groups.

New Market Dominance Standard

As discussed in Chapter 21, the proposed legislation in Senate Bill 953 would also change the process of determining market dominance to a strictly quantitative test: any rate with a revenue-variable cost ratio equal to 180 percent or greater would indicate market dominance. There would no longer be a qualitative analysis of the state of competition for the challenged traffic. Section 302 of S. 953 would amend Section 10707(a) of Title 49, United States Code to read:

> (a) In this section, 'market dominance' exists if a complainant shipper demonstrates that the challenged rate results in a revenue-variable cost percentage for the transportation to which the rate applies that is not less than 180 percent.[29]

As we discuss in Chapters 11 and 18, our examination of R/VC ratios from the CWS data suggests that the usefulness of classifying shipment-level R/VC ratios is limited by data issues and conceptual shortcomings.[30] Even in the absence of data issues with the R/VC calculations, there is little theoretical basis for treating a fixed-percentage R/VC threshold as the indicator of market-dominant behavior by railroads. The weak relationships between R/VC ratios and market structure factors imply that correctly determining the presence of market-dominant behavior requires direct assessment of the 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 not appropriate.

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[29] S. 953, 110th Congress, 1st Sess. § 302 (2007).

[30] We found two main issues with the R/VC data in the CWS. First, there is evidence of methodology changes that materially affect the measured shares of shipments exceeding 180 percent R/VC. Additionally, captivity measures based on categorizing shipment-level R/VC (or markup) data are dependent on the alignment of actual and measured costs in the tails of the R/VC distribution. Our analysis suggests that URCS costs have limitations in adequately reflecting shipment-level, cost-causing factors.

Repeal Antitrust Exemptions

Suggested Effects of Antitrust Immunity

As discussed in Chapter 21, antitrust immunity for railroads has recently come under scrutiny. Attention to this issue stems from what some critics believe are the consequences of that immunity, including:[31]

- *Railroad consolidations*. One claimed effect of the antitrust exemption is the consolidation of railroad providers.
- *Captive shippers/refusal to provide rates on bottleneck segments.* Captive shippers are a claimed result of railroad consolidations noted above. In addition, as previously reported, rail carriers have refused (with STB affirmation) to provide their captive customers with "rates to points where these rail customers can gain access to a competing railroad."
- *"Paper barriers" or "tie-in agreements."* As discussed above, paper barriers or tie-in agreements refer to certain clauses included in sales agreements or leases between Class I and smaller railroads whereby the smaller rail carrier is restricted from transacting business for the line with other major rail carriers.

Senate Bill 772

The Senate Bill 772 and the House Bill 1650 were substantially similar as introduced, but both bills were changed in committee. Focusing on the Senate Bill, S. 772 in its current form would effect the following changes:

- Railroads would no longer have immunity from injunctive relief in private civil litigation.
- Railroad agreements, mergers, and acquisitions approved by the STB pursuant to 49 U.S.C. §10706, 11321 would be subject to SEC, Maritime Commission, or Secretary of Agriculture jurisdiction and no longer be immune from antitrust scrutiny under section 7 of the Clayton Act.
- The STB would not retain its primary jurisdiction of antitrust violations of the Clayton Act and district courts where civil

[31] For example, see The Honorable Herb Kohl, Unites States Senator, Wisconsin, "An Examination of S. 772, the Railroad Antitrust Enforcement Act," Statement before the Subcomm. on Antitrust, Competition and Consumer Rights of the Senate Judiciary Comm., October 3, 2007, pp. 1-2: and Robert Szabo, Executive Director and Counsel, CURE, "An Examination of S. 772, the Railroad Antitrust Enforcement Act," Testimony before the Subcomm. on Antitrust, Competition and Consumer Rights of the Senate Judiciary Comm., October 3, 2007, p. 5.

suits are filed will not be required to defer to STB jurisdiction.

- Enforcement of compliance of various sections of the Clayton Act is no longer vested in the STB for railroad agreements, mergers and acquisitions under 49 U.S.C. §10706, 11321. In addition, under the FTC Act the Federal Trade Commission would be responsible for preventing railroads from "using unfair methods of competition in or affecting commerce and unfair or deceptive acts or practices in or affecting commerce."
- Railroads would be subject to treble damages for civil antitrust violation suits.
- The antitrust exemption for STB-sanctioned agreements under 49 U.S.C. §10706 (i.e., rate agreements) between two or more railroads would no longer exist. In conducting an antitrust analysis, the legislation would require the reviewing agency to "take into account, among any other considerations, the impact of the proposed agreement on shippers, on consumers, and on affected communities."
- The STB's exclusive authority for approval of merger/acquisition transaction would be limited (specifically excluding Clayton Act antitrust scrutiny from the STB's exclusive authority) and any antitrust exemption (under the Sherman Act, Clayton Act, FTC Act or Wilson Tariff Act) from any merger/acquisition transaction would be removed. Again, the legislation would require the reviewing agency to "take into account, among any other considerations, the impact of the transaction on shippers and on affected communities."

During the October 3, 2007, hearings on S. 772 before the Senate Judiciary Committee, various interested parties offered the following arguments for and against the elimination of the antitrust exemptions.

Arguments in favor of eliminating antitrust exemptions: [32]

- There is no good reason for the exemption.
- Other regulated industries—despite being regulated—are still subject to antitrust law.
- Railroad has been substantially deregulated—particularly rate setting—and therefore antitrust enforcement is a necessary check on railroads.
- There is a lack of competition in rail providers.
- Captive shippers are facing increased prices and/or declining service.

Arguments against eliminating antitrust exemptions:[33]

- Railroads are already subject to some federal antitrust laws.
- It would create a difficult regulatory environment because customers would have private civil injunctive relief.
- It could lead to dual enforcement concerns with regard to mergers.

From our stakeholder input, while many respondents did not believe that the proposal to remove antitrust exemptions would produce any benefits, others believed that the removal of the exemptions is needed to make the industry more competitive. Those supporting the removal of the antitrust exemptions also thought it is important for the DOJ to have oversight powers in the event of future merger proposals.

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[32] For example, see The Honorable Herb Kohl, Unites States Senator, Wisconsin, "An Examination of S. 772, the Railroad Antitrust Enforcement Act," Statement before the Subcomm. on Antitrust, Competition and Consumer Rights of the Senate Judiciary Comm., October 3, 2007, pp. 1-2; Robert Szabo, Executive Director and Counsel, CURE, "An Examination of S. 772, the Railroad Antitrust Enforcement Act," Testimony before the Subcomm. on Antitrust, Competition and Consumer Rights of the Senate Judiciary Comm., October 3, 2007, p. 1; and Darren Bush, Associate Professor of Law, University of Houston Law Center, "The Intersection of Competition Policy and Surface Transportation Regulatory Policy: An Examination of S. 772, The Railroad Antitrust Enforcement Act," Testimony before the Subcomm. on Antitrust, Competition and Consumer Rights of the Senate Judiciary Comm., October 3, 2007, p. 5.

[33] For example, see Charles D. Nottingham, Chairman of the Surface Transportation Board, "An Examination of S. 772, the Railroad Antitrust Enforcement Act," Testimony before the Subcomm. on Antitrust, Competition and Consumer Rights of the Senate Judiciary Comm., October 3, 2007, pp. 3-6, 15-18. See also Paul Moates, on Behalf of the Association of American Railroads, "An Examination of S. 772, The Railroad Antitrust Enforcement Act," Testimony before the Subcomm. on Antitrust, Competition and Consumer Rights of the Senate Judiciary Comm., October 3, 2007, pp. 3-4.

Investment Tax Credit

As we described in Chapter 21, rail infrastructure property that qualifies for the proposed tax credit includes facilities, track and ways, operating equipment, and certain other property, provided that "the cost… is chargeable to capital account."[34] The proposed legislation on an investment tax credit for railroads specifies that qualified infrastructure excludes "property which is replacing existing property" at the same location.[35] However, expenditures on "replacement or expansion of a bridge or tunnel to allow for additional clearance, track, or other capacity enhancement where such clearance, track, or other capacity enhancement did not previously exist" would qualify for the tax credit.[36] The cost of locomotive property may qualify for the tax credit if the purchased property is new, meets EPA emissions standards, and results in a net increase in "the total horsepower of all locomotives owned by, or leased to, the taxpayer" in the tax year.[37]

As we noted in Chapter 21, some industry groups have publicized their support for these bills, and certain entities commented on the investment tax credit proposals at the STB's Hearing on Rail Capacity and Infrastructure Requirements held in April 2007.[38] At this hearing, respondents acknowledged the need for increased investment in freight rail infrastructure. Multiple respondents viewed the proposed investment tax credit as a way to, as one respondent phrased it, "bridge the funding gap" between the level of investment necessary to meet growing demand for freight rail and the level of investment rail carriers are currently able to commit to infrastructure expansion.[39] However, some respondents stated that such a tax credit should be coupled with increased oversight of the rail industry and infrastructure investment in particular.[40] Many respondents noted public benefits from the use of rail

[34] S.1125, 110th Congress, 1st Sess. § 2 (a) (2007).

[35] S.1125, 110th Congress, 1st Sess. § 2 (a) (2007).

[36] S.1125, 110th Congress, 1st Sess. § 2 (a) (2007).

[37] S.1125, 110th Congress, 1st Sess. § 2 (a) (2007).

[38] This hearing predated the current bills (S. 1125, H.R. 2116), but respondents discussed the 2006 version of the proposed tax credit (S. 3742 of the 109th Congress).

[39] See, for example, Edward R. Hamberger, President and CEO of the Association of American Railroads, Comments before the Surface Transportation Board, *Rail Capacity and Infrastructure Requirements*, STB Ex Parte No. 671, April 4, 2007, p. 31.

[40] See, for example, National Grain and Feed Association Comments before the Surface Transportation Board, STB Ex Parte No. 671, *Rail Capacity and Infrastructure Requirements*, April 4, 2007, p. 5.

for freight transportation and some cited such benefits as justification for the proposed tax credit.[41]

We concluded in Chapter 16 that congestion at various points or corridors in railroad networks appears to be the major culprit in capacity-related performance issues over the last ten years. This situation is similar to the congestion and reduced throughput in communications or data networks where constraints in switching or router capacity affect the volume of services provided despite the existence of virtually unlimited fiber optic cable capacity. Regarding future capacity constraints, we concluded that forecasting capacity needs thirty years into the future is difficult, at best, and is very sensitive to future projections of economic activity. Thus, it is our assessment that one must treat these forecasts of future capacity needs as tentative, at best, particularly given the current economic climate in the U.S.

From an economic perspective, subsidies are desirable when externalities, such as congestion and pollution, exist and when the subsidies are designed to internalize the costs of those externalities. In the case of the railroads, increased investment can potentially reduce congestion on the highway network, as more highway freight transportation is shifted to rail, and potentially reduce levels of pollution. This means that the infrastructure investment would have positive externalities. Under these circumstances, a well designed subsidy system would be targeted to providing cost savings for those investments that reduce highway congestion and pollution. From this perspective, it would be desirable to target investment tax credits to those investments that specifically have these externalities.

CONCLUSION

The economic context in which we assessed the various recent proposals for policy changes is that the exercise of market power appears to have increased in the freight railroad industry over the last twenty years, allowing the railroad industry overall to obtain revenue sufficiency. While there are differences among the individual railroads, we find no evidence that the railroad industry as a whole has achieved sustained results above revenue sufficiency. By our R-1 based measure of revenue sufficiency, RPTM/ATC, the railroad industry has flirted with revenue sufficiency for a number of years, but has only achieved or surpassed it a few times in the mid-1990s and in 2006. Furthermore, the recent substantial increase in average revenue per ton-mile appears to be largely the result of increases in variable, fixed, and marginal costs—

[41] See, for example, Norfolk Southern Railway Company Statements before the Surface Transportation Board, STB Ex Parte No. 671, *Rail Capacity and Infrastructure Requirements*, April 4, 2007, pp. 15-16.

related to increases in railroad input prices and diminishing productivity growth—and not due to the increased exercise of market power. However, recognizing that differential pricing and the use of location-specific markups are necessary to achieve financial viability, in both our qualitative and quantitative research, we did find continuing concerns and issue with respect to captive shippers.

Given the structure and performance of the railroad industry, it is our opinion that among the policy proposals we examined, policies that would produce incremental changes to the industry are more likely to create favorable economic benefit/cost conditions. These include more modest open-access proposals, such as reciprocal switching and terminal agreements, and improvements in the STB's oversight and processes, such as better reporting of service quality performance data and expedited rate review. As we established, some proposals such as requirements to provide bottleneck rates, may not be workable or effective because the economics of particular situations (e.g., the loss of length-of-haul economies) will not produce the anticipated degree of competitive response. However, regardless of the particular policy proposal, we also concluded that some shippers may not benefit from policies that result in greater railroad competition (or intermodal competition for that matter) because of innate locational features. We believe that other proposed changes would result in greater economic harm for both shippers and railroads including the proposed implementation of cost standards in the STB's rate review process that are based on economically discredited methodologies and the proposal for a strictly quantitative assessment of market dominance based solely on the R/VC ratio.

Considering the experiences of the railroad and other industries with legislated access policies, the most challenging and time-consuming aspects of implementing policy changes are working out the details and doing so in a way that enhances, not diminishes, economic efficiency.

Chapter 23 Contents

CHAPTER 23 CONCLUSIONS AND FUTURE DIRECTIONS 23-1

INTRODUCTION 23-1
23A. DISCUSSION OF STUDY'S CONCLUSIONS 23-4
Trends in Rates 23-4
Economies of Density, Market Power, and Earnings 23-5
Differential Pricing 23-6
Shipper Captivity 23-7
Capacity and Performance 23-9
Economic Analysis of Proposed Changes in Railroad Industry Policy 23-9
23B. FUTURE RESEARCH DIRECTIONS 23-10
Captivity and Effective Competition 23-11
Service Quality 23-11
Capacity 23-11
Cost Shifting 23-12
Fuel Surcharges 23-12
Issues Related to Class II and Class III Railroads 23-12
Critical Evaluation of Rail Demand Growth Projections 23-13
Reduction in Railroad Network Access 23-13

CHAPTER 23
CONCLUSIONS AND FUTURE DIRECTIONS

INTRODUCTION

This report presents the findings of an independent study of the competitive state of the U.S. freight railroad industry performed by the study team assembled by Christensen Associates and commissioned by the U.S. Surface Transportation Board (STB). In conducting this study, the Christensen Associates study team has received cooperation from the STB and numerous railroad industry stakeholders including railroads, various shipper group organizations, numerous individual shippers, government organizations, academics, and other stakeholders. The study team also assembled an Advisory Panel representing a broad cross-section of industries, groups, and stakeholders. Members of this Advisory Panel, who are listed in Appendix 5-A in Volume 1, provided much-appreciated insights during the various stages of our study. While valuable insights and assistance were obtained by the study team from these various groups and our Advisory Panel, no individual, government agency, railroad, shipper, or any other industry stakeholder has exerted any influence on the findings of this study. The findings presented and conclusions reached in this report represent the professional judgments and opinions of the Christensen Associates railroad study team.

The U.S. Government Accountability Office (GAO) has issued several reports on the freight railroad industry since the passage of the Staggers Rail Act in 1980. These documents are largely in response to Congressional concerns over the appropriate balancing of railroad and shipper interests, and the continued viability of the railroad industry and its ability to fulfill demands for its services:

> Policymakers continue to believe that the federal government should provide a viable process to protect shippers against unreasonably high rates, as well as address competition issues, while still balancing the interests of both railroads and shippers. Over the past 10 years, significant consolidation has taken place in the freight railroad industry, while railroads—particularly Class I railroads—have seen their productivity and financial health improve. Railroad officials worry that any attempt to increase economic regulation will reduce carriers' ability to earn sufficient

> revenues and limit future infrastructure investment. At the same time, a number of academic and government studies are predicting a significant increase in the demand for freight rail over the next 10 to 15 years.[1]

The 2006 GAO report noted that, after a long-term downward trend in railroad rates since the passage of the Staggers Act, increases began to occur in the early 2000s:

> Between 1985 and 2000, rail rates generally declined, but then increased slightly from 2001 through 2004. Although rates have declined since 1985, they have not done so uniformly, and rates for some commodities are significantly higher than rates for others. Several factors could have contributed to recent rate increases, including broad changes in the domestic and world economy, the emergence of a capacity constrained environment in which demand exceeds supply, and consolidation in the 1990s in the industry leading to changes in competition. Other costs, such as fuel surcharges, have also shifted to shippers, …[2]

The question posed by the GAO was whether the observed pattern in railroad rates was the reflection of economic market forces or "a possible abuse of market power" exerted against captive shippers by railroads:

> Some concerns about competition and captivity in the industry remain because traffic is concentrated in fewer railroads. It is difficult to determine precisely how many shippers are captive because available proxy measures can overstate or understate captivity. In addition, STB does not accurately collect railroad revenue data. Nevertheless, our analysis of available measures indicates that the extent of captivity appears to be dropping, but the percentage of industry traffic traveling at rates substantially over the statutory

[1] Government Accountability Office, Freight Railroads: Industry Health has Improved, but Concerns about Competition and Capacity should be Addressed, October 2006, pp. 1-2.
[2] Government Accountability Office, Freight Railroads: Industry Health has Improved, but Concerns about Competition and Capacity should be Addressed, October 2006. p. 3.

> threshold for rate relief has increased. For example, the amount of traffic traveling at rates over 300 percent of the railroad's variable cost increased from 4 percent in 1985 to 6 percent in 2004. Furthermore, some areas with access to one Class I railroad have higher percentages of traffic traveling at rates that exceed the statutory threshold for rate relief. These findings may reflect reasonable economic practices by the railroads in an environment of excess demand, or they may indicate a possible abuse of market power.[3]

Prompted by the GAO's findings and questions, we were tasked with examining the competitive state of the U.S. freight railroad industry. In addressing this issue, we examined whether the current situation reflects reasonable economic practices by the railroad industry overall. Our task also involved the economic analysis of recent legislative proposals for railroad industry policy changes. Our year-long examination of the various facets of the competition issue leads us to the following conclusions:

- Class I railroads' rates (real revenue per ton-mile) rose substantially above marginal cost in 2006.
- Economies of density and fixed costs require railroad pricing above marginal cost to achieve revenue sufficiency.
- For most years in the 1987 to 2006 period of our study, the Class I railroad industry's earnings do not appear to be above normal profits.
- The increase in railroad rates experienced in recent years is the result of declining productivity growth and increased costs rather than the increased exercise of market power.
- Railroads use differential pricing, including the use of location-specific markups, to recover their total costs.
- Different commodity groups face different markups of railroad rates over marginal costs.
- Within commodity groups, shippers with no or very limited transportation options tend to pay higher rates than shippers with the same shipment characteristics who enjoy more or better transportation alternatives.

[3] Government Accountability Office, Freight Railroads: Industry Health has Improved, but Concerns about Competition and Capacity should be Addressed, October 2006, p. 3.

- The ratio of revenue to URCS variable cost (R/VC) is weakly correlated with market structure factors that affect shipper "captivity," and, thus, is not a reliable indicator of market dominance.
- Capacity "tightness" is primarily due to congestion at terminals or other specific network locations. Terminal congestion in the 2003-2005 period was linked to service performance declines during that time period.
- There is little room to provide significant rate relief to certain groups of shippers without requiring increases in rates for other shippers or threatening railroad financial viability.
- Incremental policies such as reciprocal switching and terminal agreements have a greater likelihood of resolving shipper concerns via competitive response, and have a lower risk of leading to adverse changes in industry structure, costs, and operations.
- Some shippers will not benefit from efforts to enhance railroad competition, implying the necessity of continued regulatory oversight.

While the GAO questioned whether the recent performance of the U.S. freight railroad industry is indicative of a possible abuse of market power, our analysis provides evidence on whether there has been a change in the exercise of market power by U.S. railroads. As we have established, by definition, the setting of price above marginal cost is the exercise of market power, but exercise does not imply abuse. To address the question of whether there has been an "abuse of market power" would require judgments as to the fairness of the distribution of value between the railroads and the shippers, and on the distribution of the overhead cost collection among the shippers. These judgments are policy questions and not resolvable through economic analysis alone. Instead, we have answered the economic questions of the extent to which recent railroad pricing behavior reflects changing cost conditions, and the extent to which it represents an increase in the overall exercise of market power. Furthermore, our analysis has shed light on how recent railroad pricing behavior has shifted the burden of overhead cost collection among the different sets of shippers.

23A. Discussion of Study's Conclusions

Trends in Rates

While overall railroad prices were fairly stable-to-declining for a long period of time in the post-Staggers Act period, rates have increased

substantially in the last few years. Since the early 2000s, rates generally began to go up, creating questions about the possible abuse of market power in the increasingly concentrated freight railroad industry.[4] Much of the observed rail rate increase can be explained by examining the railroad industry's input prices and productivity growth. In recent years, railroad input price growth has generally increased across most categories (not only fuel) and, at the same time, the industry's productivity growth has slowed. Thus, overall unit costs for railroads have gone up in recent years after reaching a minimum at the end of 2002.

The trends in the STB's measure of railroad productivity generally follow the railroad industry's productivity trends measured by the U.S. Bureau of Labor Statistics (BLS). The BLS index shows that while productivity increased during the pre-Staggers era, there was a substantial increase in productivity growth during the 1980s and into the 1990s. Beginning in the 1990s, the rate of railroad productivity growth began to decrease (i.e., productivity growth was less rapid). Railroad productivity growth was much more rapid than productivity growth in the U.S. private business sector up until 2000, but since 2000 the railroad industry and the U.S. private business sector have had very similar rates of productivity growth. The implication of this slowdown in productivity growth for the railroad industry is that increases in railroad costs will more likely be passed through to shippers rather than being absorbed (fully or partially) by productivity gains.

Economies of Density, Market Power, and Earnings

Economies of density arise when the average cost of serving customers decreases as the volume of business increases over the network. When economies of density are present, the Econ 101 textbook example of marginal cost pricing does not produce enough revenue to cover a firm's total cost, and alternative pricing or funding mechanisms must be found. Differential pricing (i.e., charging different price markups over marginal costs to different customers or customer classes) is recognized in the economic literature as a pricing method that might be employed when an industry experiences economies of density. As is the case with many other network industries, the railroad industry engages in differential pricing, where different customer groups face different levels of price markup over marginal costs.

We draw several basic conclusions from our analysis of the aggregate railroad industry's costs and revenues:

[4] For example, see GAO Report to Congressional Requesters, "Freight Railroads Industry Health Has Improved, but Concerns about Competition and Capacity Should Be Addressed," October 2006, pp. 11-15.

- Economies of density are consistently the primary factor driving the markup of price over marginal cost for railroads.
- The average size of the markups over marginal cost appears to have increased in the freight railroad industry over the last twenty years but, for the most part, has not generated excess profits. The largest markup increases appear to occur in periods when marginal cost is declining, not when the railroads' prices are increasing.
- The larger markups that have occurred over the last twenty years have been necessary in order for railroads to obtain revenue sufficiency. That is, at an aggregate level, the markup of marginal cost has increased over time, but it does not appear that excess net revenue was generated. For most years in the 1987 to 2006 period of our study, the Class I railroad industry's earnings do not appear to be above normal profits.
- The fact that railroads have achieved revenue sufficiency, but not excess profits, is borne out by the financial market's assessment of industry performance. Railroad financial performance is generally consistent with that of electric utilities, with earnings per share and price-earnings ratios in the same range as those for electric utilities and the average of S&P 500 companies.
- The recent substantial increase in revenue per ton-mile appears to be largely the result of increases in variable, fixed, and marginal costs, and not due to the increased exercise of market power.
- Our economic cost results are largely consistent with the pattern of slowing industry productivity growth and rising input price growth that has been occurring in the railroad industry since the mid-2000s.

Differential Pricing

While our overall assessment of the railroad industry provides a meaningful perspective, there are important and more detailed issues that do not stand out in the aggregate analysis. To help focus on market segments that may not be performing according to competitive standards and may possibly suffer from the exercise of railroad market power, we analyzed price mark-ups over marginal cost for various categories of shippers. From an economic perspective, we would expect a railroad to charge higher markups over costs to those shippers whose demands for rail services are perceived by the railroad to be relatively inelastic. The perceived demand elasticity would in general depend on factors including the product being shipped, shipper characteristics, and the

availability of railroad and non-railroad shipping competition for the whole or segments of the shipment's route.

The markup patterns by commodity that we calculated are mostly consistent with our expectations and with the information we gathered from industry stakeholders and our review of the literature during our qualitative research. We would expect lower markups for less time-sensitive, bulk commodity shipments, which is largely borne out by the results for coal, ores, and nonmetallic minerals. Grain shippers appear to be justified in believing they are paying relatively high markups, though this result may be due in part to the system of railcar placement auctions, which we would expect to extract higher prices from shippers with low demand elasticities.

An important issue that lies at the heart of the debate over policy proposals for the railroad industry is whether there is sufficient effective competition to keep railroad pricing at rates that are "reasonable" for railroads to achieve revenue sufficiency. Our economic models allow for both intramodal and intermodal competition in limiting railroads' market power, but do not specify which forms of competition will provide the most binding constraints on railroad pricing or the magnitudes of these price effects.

From our analysis of particular commodity groups, we find generally expected effects on rail rates from increasing railroad competition at the origin and from increasing the distance from the origin to the nearest available water transportation. That is, rates generally tend to be lower given increased competition from other railroads or from increased proximity to water transportation alternatives at the origin, and higher for shippers with more limited railroad and water options at the origin. However, the existence of competitive responses is double-edged: shippers lacking railroad or intermodal alternatives are at least relatively "captive" in the sense that they pay higher rates (which may or may not exceed quantitative markup thresholds for market-dominance tests) for shipments with the same cost characteristics as those of more favorably situated shippers.

Shipper Captivity

The 2006 GAO report found that while tonnage traveling at 180 percent or higher R/VC was generally declining between 1985 and 2004, traffic moving at more than 300 percent R/VC increased substantially in this period. We found similar results comparing 2000-2001 and 2005-2006 CWS data. However, our examination of R/VC ratios from a CWS panel of data suggests that the utility of classifying shipment-level R/VC ratios is limited by data issues. Even in the absence of data issues with R/VC calculations, there is little basis for treating a fixed percentage

R/VC threshold as the indicator of market-dominant behavior by railroads.

From an economic perspective, “relative captivity” arises for shippers whose next best alternatives do not effectively constrain railroad rates. The effects of captivity may be continuous and have no definite relationship to markup thresholds. For instance, a shipper may pay a rail rate under the 180 percent R/VC threshold and nevertheless experience a degree of “captivity” relative to other shippers with similar cost characteristics because other shippers have better access to intramodal or intermodal competition that results in lower rail rates. Conceptually, more appropriate measures of captivity should focus on the effects of the transportation market structure on rail rates—and, by extension, markups—rather than on markups as indicators *per se* of market-dominant behavior. The R/VC ratio does not appear to perform well as a proxy for conceptually more appropriate market structure measures. We found that R/VC is weakly related to measures of railroad and water competition.

The R/VC ratio, applied prudently, may be able to identify categories of shipments that travel at high rates relative to costs, but the R/VC ratio is not very useful as an indicator of the presence of market structure factors that would increase a shipper’s “captivity” to an individual railroad. 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 not appropriate.

The specific market structure factors that drive competitive responses also have implications for policies intended to provide relief to captive shippers. The absence of railroad competition is at least theoretically responsive to policies that would facilitate shippers’ access to competing railroads, such as reciprocal switching and terminal access agreements. However, our results for the effects of water competition indicate that some shippers are subject to relatively high rates because of features of shipment geography that are not amenable to railroad-focused policy initiatives. In some cases, it might be possible for shippers and/or shipment recipients to relocate in order to maximize the benefits of modal competition. However, some economic activity may not be amenable to relocation—for example, wheat production in the Western and Northern Plains. Shipper captivity that is driven by unavoidable limitations of shipment geography will tend to require regulatory monitoring to ensure that prices do not reflect the exercise of local market power determined to be “unreasonable.”

Capacity and Performance

Congestion at various points or corridors in railroad networks appears to be the major culprit in capacity-related performance issues over the last ten years. While other measures of capacity along a given route may indicate sufficient capacity to meet demand, congestion at terminals or other specific network locations can often become a binding constraint on the utilization of route capacity or network-wide capacity. Furthermore, the relationship between increased network congestion (represented by terminal dwell times) and diminished railroad performance (represented by train speed) illustrates the complex interaction between a number of factors that affect a railroad's ability to provide service and its resulting productivity. The capacity of railroad networks to provide service is similar to that of communications and data networks where throughput is often limited by constraints on switching or router capacity despite almost unlimited "corridor capacity" in fiber optic cable.

Post-Staggers declines in Class I miles of track have stabilized in recent years and track continues to be used more intensively, as net ton-miles per mile of track continue to increase.[5] Railcar and locomotive data suggest fluctuations over time, with flat-to-declining values in the early to mid-2000s. Recent years have seen an increase in spending as well as in the number of units. Other aggregate measures of railroad capacity indicate that, overall, excess capacity may still exist. Combined with a relatively weak economy, all of this indicates that any capacity tightness that may have existed at the beginning of this decade has likely loosened in recent years.

Economic Analysis of Proposed Changes in Railroad Industry Policy

The economic context in which we assessed the various recent proposals for policy change in the railroad industry is that the markups of prices above market cost appear to have increased in the freight railroad industry over the last twenty years, but this markup pricing has been necessary in order to obtain revenue sufficiency. Only in the most recent year of our analysis does industry revenue noticeably exceed industry cost. Furthermore, the recent substantial increase in revenue per ton-mile appears to be largely the result of increases in variable, fixed, and marginal costs—related to increases in railroad industry input prices and diminishing productivity growth—and not due to the increased exercise of market power. While recognizing that differential pricing and the use of location-specific markups are necessary to achieve

[5] As indicated above, some but not all of the decline in Class I miles of track has been offset by increases in regional and shortline track miles.

financial viability, in both our qualitative and quantitative research, we did find lingering concerns and issues with respect to captive shippers.

Given the current structure and performance of the railroad industry, it is our opinion that of the policy proposals we examined, policies that would produce incremental changes to the industry are likely to create more favorable economic benefit/cost conditions than more sweeping policy changes. The proposals with incremental impacts include more modest open access proposals, such as reciprocal switching and terminal agreements, and improvement in the STB's oversight and processes such as improved CWS data quality controls, better reporting of service quality performance, and—possibly most significantly—expedited rate review. As we established, some proposals such as requirements to provide bottleneck rates, may not be workable or effective because the economics of particular situations (e.g., loss of economies of density and/or length-of-haul economies) will not produce the anticipated degree of competitive response.

Regarding the assessment of market dominance, 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 not appropriate.

Based on the experiences of the railroad and other industries with legislated policies, the most challenging and time-consuming aspect of implementing policy changes is working out the details and doing so in a way that enhances, not diminishes, economic efficiency.

23B. FUTURE RESEARCH DIRECTIONS

In addition to the research the Christensen Associates study team performed in the course of our year-long study and our conclusions from that research, we believe there are a number of areas where future research efforts would improve the understanding of the U.S. freight railroad industry. A number of these potential research issues came up during the course of our stakeholder interview process but were outside the scope of the current study. In the case of some issues, the current lack of adequate data prevents a thorough empirical examination. We see other areas as a natural extension of the research we have performed for this study. The topical list below is in no particular order of importance, nor is it meant to be an exhaustive list of pertinent topics in the railroad industry that merit further investigation.

Captivity and Effective Competition

For the reasons we stated above and elsewhere in this report, we strongly believe that measuring and assessing captivity through the use of "bright-line" standards such as R/VC is economically deficient. The weak relationships we found 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. A better empirical understanding of the economic dimensions of rail shipper captivity is critical, particularly in light of proposed regulatory reforms that would establish R/VC tests as the sole quantitative indicator of a railroad's market dominance.

Service Quality

In our stakeholder research, service quality issues—particularly on-time performance, variability of performance, and the relationship between captivity, rates, and service quality—were key concerns for many shippers. We were able to assess these issues at a highly-aggregated level with our analyses of RPM data. However, because detailed data are not readily available by, for example commodity, route, or locational characteristics, many of the concerns expressed by shippers could not be thoroughly evaluated during this project.

To evaluate many of the shippers' service quality concerns at more than aggregate or anecdotal levels, data that capture service performance metrics at a disaggregate level are necessary. As we noted, one member of our Advisor Panel indicated to us that railroads as well as many shippers record and keep data on service metrics such as cycle times. While such information is likely confidential, it was suggested that the STB may need to require the reporting of this type of data—possibly by route or by commodity—to better identify and rectify service quality issues. As one step in this direction, perhaps the reporting of complaint statistics on the STB website could be expanded (without breaching confidentiality).

Capacity

Another area that would benefit from a more disaggregate analysis is railroad capacity, particularly given our conclusion that capacity "tightness" issues have most likely been due to localized congestion and constraints, and not because of a system-wide lack of capacity. As we noted, we think the approach taken by Burton is promising in this respect. Also, more disaggregated RPM-type data on railroad performance would be helpful to better investigate capacity issues as well as service quality concerns.

Another aspect of railroad capacity that was brought up in our stakeholder interview process is whether railroad equipment markets operate efficiently, supplying the appropriate amount of equipment. We discussed some of the issues that appear to be relevant to this potential research area in Chapter 5.

Cost Shifting

A number of stakeholders indicated to us that there has been a significant amount of "cost shifting" in recent years, whereby costs or investments that were previously undertaken by railroads are now the burden of shippers. Examples of cost shifting to shippers include increases in investments in track and storage facilities, loading and unloading facilities, car ownership and maintenance, and accessorial charges. Another form of cost shifting involves the feedback we received during our interview process that service quality problems imposed additional costs on shippers—for example the need to carry greater inventories or larger railcar fleets.

We have been able to examine some of these issues—for example, the increase in third-party car ownership and our empirical results that indicate rates are generally lower across a number of commodity groups when shipper-owned cars are used. However, many of the cost-shifting issues appear to require additional data to enable a thorough empirical investigation. To the extent such issues are critical to shippers, the STB may consider requesting that appropriate data be made available to investigate these cost-shifting concerns.

Fuel Surcharges

Although the STB has recently begun to collect data on fuel surcharges, these data have not been collected long enough at this point in time to perform a reasonable analysis. For example, the effectiveness of the new STB rules on fuel surcharges has yet to be fully evaluated. As we noted in Chapter 5, an opinion expressed to us in our stakeholder interviews is that the STB did not get the rules "right" and railroads were still manipulating the system; evidence supporting this concern is the wide variation in the fuel surcharges data that "makes no sense."

Issues Related to Class II and Class III Railroads

As discussed in Chapter 5, some smaller railroads expressed a number of concerns, including the relationship between smaller and Class I railroads with respect to following:

- Class I railroads "cherry pick" traffic; they are primarily interested in long-haul movements and don't want a lot of the

shorter-haul manifest traffic that is profitable for the smaller railroads, resulting in a loss of potential business for smaller railroads.

- Pricing by Class I railroads often works to the detriment of smaller railroads. Smaller railroads often find that they are unable to generate or keep business because the prices for the Class I part of the movement are too high. As a result, smaller railroads often lose business to trucks.
- Class II and III railroads that interline with Class I railroads often do not have control over service quality (e.g., variability of delivery times) because the Class I railroads ultimately determine the service quality for the entire movement.

In addition, because many of their networks consist of abandonments of Class I railroads' less well maintained routes, smaller railroads have had to undertake significantly greater investments (proportionately speaking) than Class I railroads. Some shippers also opined that some shortline networks are seriously underfunded.

We believe that research on these issues is warranted and, generally, how Class II and II railroads contribute to the performance of the U.S. freight railroad industry.

Critical Evaluation of Rail Demand Growth Projections

There are a number of studies that project a widening gap between the demand for rail services and railroad capacity—e.g., the Cambridge Systematics study commissioned by the AAR. These demand projections provide a basis for projecting investment needs and support for the importance of continued railroad earnings growth.

Because of the important implications of these demand projections, there needs to be a critical evaluation of these projections and rail capacity needs. Supporting this need for a critical evaluation, we have heard in our interviews that the projections of long-term rail demand are overstated by many studies and, thus, the demand-capacity balance may not be as "painful" as these studies predict.

Reduction in Railroad Network Access

A concern expressed to us by a number of agricultural shippers was the reduction in railroad network access points. As discussed in Chapter 5, potential research questions here include the extent of reduced access, whether it has resulted in efficiency gains, and whether it has shifted costs to other modes of transportation (such as increased highway maintenance costs).

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