“Protecting Captive Freight Rail Shippers in the US: The Past, the Present, and Possible Ways Forward”

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Efficient recovery of fixed costs in railroads requires differential pricing…

- Economists' "first best" policy – marginal cost pricing – requires government subsidies for the infrastructure
- If subsidies are unavailable, an efficient "second best" policy is differential (or "Ramsey") pricing:
  - Low mark-ups over cost for traffic with elastic demand for rail – i.e. shippers with economical alternatives to rail
  - High mark-ups over cost for traffic with inelastic demand for rail – i.e. shippers with no economic alternatives to rail

… For example …

- Bulk cargoes, especially going long distances, have inelastic demand for rail transport, can pay high mark-ups over cost
- Same for hazardous materials that policy makers want to keep off the roads
- Containers are “footloose” – have elastic demand for rail transport – will move to all-road or water if rail mark-ups too high
- Manufactured goods traveling in freight cars may be in between
- This applies whether pricing is for the service or for infrastructure access

… BUT policy makers may want to set limits on mark-ups.

- Stated otherwise: What limits can or should be set on "monopoly exploitation" of rail shippers with inelastic demand?
- European-style restructuring – vertical separation or 3rd party access – usually solves the problem directly (Professor Nash)
  - If rate offered is too high, independent train-operating company (TOC) can enter and "skim the cream"
  - This TOC may be created by the shipper itself
- Americas-style restructuring – dividing rail system into competing, vertically integrated railroads – does not
  - This reform model inherently creates geographic areas monopolized by one railroad
  - Different regulatory solutions in the US and Canada

US: Staggers Rail Act of 1980

- In background: Regulator has allowed mergers to concentrate industry; most broad regions served by only 2 railroads
- Railroads generally free to set rates, encouraged to “Ramsey-price”
- However, freedom to Ramsey-price is not unlimited. “Captive shippers” may challenge rates at Surface Transportation Board
- Shippers are “captive” if they demonstrate:
  - They have no “economic alternative” to shipping on the single railroad company that serves them; AND
  - The rate charged is at least 180% of the variable cost of serving them, where
  - Variable cost is measured using a very specific (and controversial) tool called the Uniform Rail Costing System.

Criteria for a rate challenge in the US

- Captive shippers may challenge their rates under one or more of 3 criteria:
  - The revenue adequacy constraint: Shippers may not be required to pay more than is necessary to keep the railway company "financially sound";
  - The management efficiency constraint: Shippers may not be required to pay for a railway company's inefficient business practices; and
  - The stand-alone-cost constraint: Shippers may not be required to "cross-subsidize" other shippers by paying more than the revenue that would be necessary to pay for a dedicated railroad serving them.

Regulatory outcomes in the US

- In practice:
  - Revenue adequacy has never been the basis for a successful challenge.
    - However, in the most recent rate case (*Consumers Energy v. CSX*), the STB considered a challenge under this test, denied it, but noted that railroad companies are now generally "revenue adequate" (a regulatory term of art), so that this test may be the basis for a successful challenge in the future.
  - Management inefficiency has never been the basis for a successful challenge.
  - All successful, and almost all unsuccessful, challenges have been under the stand-alone-cost test.
    - Shippers complain that rate ceilings under this test are quite high.
    - There is increasing dissatisfaction with this test – based on both the economic rationale and the expense of implementation – including by the STB itself (again, see *Consumers Energy*).

Proposals for reform

- As in Mexico, consideration of both rate ceilings and competitive access
- Option 1: Improve or replace the stand-alone-cost test for determining rate ceiling
  - “Simplified” versions of the stand-alone-cost test have been crafted, but rarely used
  - Other methodologies for rate ceilings?
    - “Competitive rate benchmarking”: Professor Wolak
    - Commodity-based ceilings on mark-ups
    - “Incumbent Network Cost Analysis” (Limited geographic area rate-of-return regulation): STB Rate Reform Task Force

Proposals for reform, continued

- Option 2: Provide shippers with regulatory option to demand "switching"
  - In principle, shipper can today seek an order for the serving railroad to "switch" traffic to a competing railroad at the nearest junction (sometimes termed the Canadian regime: Dr. Andic)
  - Never used due to stringent regulatory requirements
  - STB currently considering easing these requirements
  - BUT requires 2nd railroad to offer competitive rate
- Option 3: Remove partial antitrust immunity of railroads
  - Intended to lead also to "switching" orders, perhaps through refusal-to-deal cases

Overall lessons?

- European-style reforms – vertical separation and 3rd party access – give some inherent protection to captive shippers, but have their own disadvantages
- Americas-style reforms (Mexico, Brazil) have some advantages but create inherent problem of regional monopolies, captive shippers
- Alternative methodologies for protecting captive shippers under Americas-style reforms, all admittedly imperfect:
    - Rate ceilings of various kinds
    - Mandatory switching or trackage rights – but these require a willing competitor, and in concentrated systems, competitor may not be willing
- Railroad companies: "Surely you don't want Jones back!"