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

Russell Pittman
Antitrust Division, U.S. Department of Justice
First International Colloquium of the Economics and Regulation of the Mexican Freight Rail Industry”
Agencia Reguladora del Transporte Ferroviario
Mexico City, July 3, 2019

The views expressed are not purported to reflect those of the U.S. Department of Justice.
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 3\textsuperscript{rd} 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!”