Reregulating Railroads Is the Wrong Track for Consumers

Several decades ago, Congress significantly reduced federal regulations on U.S. freight railroads. In the period that followed, industry competition intensified, leading to increased productivity, lower transportation costs and widespread consumer benefits. Despite these improvements, some have shown interest in reregulating the railroad industry. A look back into the history of deregulation demonstrates why reregulation would result in negative consequences for American consumers.

Overview

The transportation sector today can be characterized by interindustry rivalry between barge transport, railroads, interstate and local trucks, other motor vehicles and airlines. Within the sector, privately owned U.S. freight railroads have a major impact on the economy, covering 140,000 miles of track. Analysis of the most recent data available shows the sector contributes $274 billion in total economic output, provides 1.5 million direct and indirect jobs across the country and adds roughly $26 billion in private infrastructure investment each year.[1] One-third of exports and 40% of intercity freight are transported by rail. The rail industry was recently rated highest among the key sectors for infrastructure efficiency and maintenance.[2]

Yet, this economic success was not always the case prior to 1980, when the railroads were heavily regulated by the Interstate Commerce Commission (ICC). Considering recent attempts to impose new and onerous rules on the industry, a review this deregulatory history

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[1] Daraius Irani, "Economic and Fiscal Impact Analysis of Class I Railroads," Regional Economic Studies Institute, Towson University, September 28, 2016, https://gbc.org/wp-content/uploads/2016/09/Daraius-Irani-presentation-092816.pdf.

[2] Lauren Thomas and John W. Schoen, "Engineers Give America's Infrastructure a Near Failing Grade," CNBC, March 9, 2017, http://www.cnbc.com/2017/03/09/engineers-give-americas-infrastructure-a-near-failing-grade.html. This article shows railroads receiving a "B" grade – the highest grade among the 16 sector "D" average.

can clarify to regulators and policymakers how to avoid creating new burdens that stifle economic growth and hurt American consumers.

Regulatory Reforms and Consumer Benefits

In 1887, the ICC was established to prevent railroads from setting abusive rates. Over time, regulations seriously inhibited competition, rebating and discounting, while controlling what could be shipped and at what price.

During the 1970s, the accumulation of these onerous regulations threatened the financial viability of the rail industry. Unprofitable routes were preserved by a prohibition on abandonment, and the railroads were forced to use inefficient balkanized route structures that lacked an end-to-end footprint. Rates were heavily regulated and subject to collective ratemaking. These conditions, coupled with the development and emphasis on the interstate highway system, led to railroads' losses of high-margin traffic to other modes of transportation, primarily trucking. From 1962 to 1978, railroads' investment returns averaged only 2.42% – substantially lower than a regulated fair rate-of-return.[3]

After Penn Central Railroad's bankruptcy, there was congressional talk about saving the railroads, including a costly bailout and nationalization of the industry. In the end, Congress opted to reduce industry regulations through passage of the Railroad Revitalization and Reform Act of 1976 and the Staggers Rail Act of 1980. The aim of these laws was to revitalize the financial viability of the railroads and to improve deteriorating service. To encourage restructuring and reassessment of operations, railroads were permitted flexibility in pricing, end-to-end mergers and abandonment of unprofitable lines.

What followed were unparalleled improvements in financial strength and improvements in service quality, including rail costs falling by half and productivity tripling in the period

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[3] Robert G. Harris and Theodore E. Keeler, "Determinants of Railroad Profitability: An Econometric Study," *Economic Regulation: Essays in Honor of James R. Nelson*, 1981, p. 37.

following legislative action. In terms of benefits to shippers and consumers, transportation prices fell by 4% in the first two years, 20% in five years and 44% in 10 years following deregulation.[4] Today, the consumer benefits of railroad deregulation produce nearly $10 billion in annual economic benefits for consumers – all due to lower-priced goods resulting from lower transportation costs.[5]

Reducing regulations saved the rails from bankruptcy, increased industry and encouraged intermodal competition while lowering transportation costs and significantly improving consumer welfare. Like other transportation modes, efficient operations drove down costs, which were passed on to finished products and consumer-facing retail operations.

Over time, shippers that fought against deregulation at the time became major beneficiaries of reduced regulations. Seminal research from the Brookings Institution and American Enterprise Institute estimated that rail cost reductions yielded 65% lower prices for shippers and, ultimately, consumers.[6]

For consumers, shippers and railroads, deregulation was a clear policy success. As for the regulator, the ICC was abolished and replaced by the U.S. Surface Transportation Board (STB) – an independent agency as of 2015 "charged by Congress with resolving railroad rate and service disputes and reviewing proposed railroad mergers," according to the STB's website.[7]

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[4] The studies on the consumer benefits from regulatory reform are too numerous to list here, but a sampling of some highly cited work would include Sam Peltzman and Clifford Winston, *Deregulation of Network Industries – What's Next?*, AEI-Brookings Joint Center, 2000 (including chapter 2, Curtis Grimm and Clifford Winston, "Competition in the Deregulated Railroad Industry," pp. 41-72); Robert Crandall and Jerry Ellig, "Economic Deregulation and Customer Choice – Lessons for the Electric Industry," Mercatus Center, George Mason University, 1997; Clifford Winston, et. al., *The Economic Effects of Surface Freight Deregulation*, Brookings, 1990; Elizabeth E. Bailey, "Price and Productivity Change Following Deregulation: The U.S. Experience," *The Economic Journal*, March 1986; and Paul W. MacAvoy, *The Natural Gas Market: Sixty Years of Regulation and Deregulation,* Yale University Press, New Haven 2000.

[5] These are consumer welfare benefits. See, Ernst R. Berndt, Ann F. Friedlaender, Judy Chiang and Christopher A. Vellturo, "Mergers, Deregulation and Cost Savings in the U.S. Rail Industry," NBER Working Paper no. 3749, June 1991.

[6] Clifford Winston, "The Success of the Staggers Rail Act of 1980," AEI-Joint Center for Regulatory Studies, publication 05-24, October 2005, p. 8.

[7] See the STB website at https://www.stb.gov/stb/about/overview.html.

New Regulatory Threats

Historical regulatory reforms have benefited consumers, which is why efforts to reregulate the freight rail sector is concerning for members of Congress (who recently reauthorized the STB), the freight rail sector and the beneficiaries of its operations – including the shippers not actively seeking changes. Among several new proposed regulations on the horizon, the STB is looking to revise regulations that affect how competitors can use another railroad's assets and facilities – referred to as *reciprocal switching regulations*.[8]

These reciprocal switching regulations were proposed by an association of shippers.[9] The proposal would require one railroad to turn over its traffic to another railroad, and do so (potentially) at below-market rates. If imposed, these "forced access" regulations would discourage rail investment, invite stricter rate regulation, lead to cross-subsidization and impede competition. Switching traffic between railroads would undoubtedly create inefficiencies, delays and higher costs for railroads, which would ultimately mean higher transportation costs for moving the same freight. Moreover, if rates are not fully compensating – covering variable and fixed costs – then these proposed regulations will undermine the final strength of the railroads, including the basic infrastructure on which shippers rely.

Nearly 20 years ago, a similar regulation of sharing was attempted, where incumbent broadband services facilities (referred to as *unbundled network elements*) would be provided to their competitors at below-market prices. However, prominent economic studies concluded that artificially low wholesale prices would produce devastating consequences for industry investment and consumers. Specifically, one study found that unbundled network element prices gave incumbent telecommunications operators only 42% of their normal retail revenues.

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[8] "Petition for Rulemaking to Adopt Revised Competitive Switching Rules," STB, Docket No. EP 711, July 25, 2016, https://www.stb.gov/decisions/readingroom.nsf/dfb91c6e770f611085256f2b007479f0/11dff4d3703b81a885257ffd00475d63?OpenDocument.

[9] Jeff Berman, "STB Rolls Out Proposed Reciprocal Switching Regulations," *Logistics Management*, July 28, 2016, http://www.logisticsmgmt.com/article/stb_rolls_out_proposed_reciprocal_switching_regulations.

And as other economists noted, it would take 20 years of productivity-based price reductions to match the one-time shift to lower wholesale prices.[10] Because of the onerous cost of regulations, massive losses of earnings and the risk associated with renting facilities to competitors at bargain prices, incumbent operators were discouraged from investing in broadband services.[11] In response, the regulations were revamped, and broadband investment almost immediately increased.[12]

Like economies of scale in broadband networks, railroads have high fixed costs and must invest heavily in their infrastructure to safely and efficiently move products, some of which are hazardous and therefore require extreme care. Achieving and maintaining a superior condition of rail infrastructure requires diligent investment and attention to safety. Incentives to reduce investments would only hinder shippers' ability to move these goods.

In fact, new analysis commissioned by proponents of forced access shows local switching can result in significant delays and that the problem is likely to worsen.[13] Recent, scholarly commentary argued that the proposed regulation was a subtle scheme to reduce rates for select railroad shippers at the expense of others. As the Phoenix Center's George S. Ford concluded, "Reciprocal switching is regulatory activism, not competition policy."[14] In short, a forced access rule would be a big step backward for deregulation, investment and consumers.

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[10] Randolph J. May and Larry F. Darby, FCC Comments of the Progress and Freedom Foundation, CC Docket N. 01-338, N. 96-98 and No. 98-147, 2002, p. 24; and Alfred Kahn, Timothy Tardiff and Dennis Weisman, "The Telecommunications Act at Three Years: An Economic Evaluation of Its Implementation by the Federal Communications Commission," *Information Economics and Policy*, Vol. 11, 1999, pp. 330-32.

[11] Steve Pociask, "Competition at Bargain Prices," *America's Network*, December 15, 1998.

[12] The history of and link between broadband regulations and industry investment is available in Steve Pociask and Joseph P. Fuhr, "Concentration by Regulation," American Consumer Institute, January 2016.

[13] "Transporting growth: Delivering a Chemical Manufacturing renaissance," PWC for the American Chemistry Council, March 2017, https://www.americanchemistry.com/Transporting-Growth-Delivering-a-Chemical-Manufacturing-Renaissance.pdf.

[14] George S. Ford, "Stop the Surface Transportation Board from running off the rails" *The Hill*, January 18, 2017, http://thehill.com/blogs/pundits-blog/transportation/314677-stopping-the-surface-transportation-board-from-running-off.

The STB is also focusing on several new areas of reregulation. One is a return to commodity regulation, in which regulators would deem certain commodities as noncompetitive, thereby inviting rate regulation for shipping these commodities.[15] Another regulation deals with railroad "revenue adequacy" – a regulation originally aimed at helping railroads achieve financial stability but that is now being used to cap profits and prices.[16] Both rules have come about in the absence of any empirical justification demonstrating how changes in the market structure, conduct or performance would suggest a need for a regulatory remedy.

The Federal Railroad Administration (FRA) – which oversees the safety operations of railroads and over time has mandated policies tied to almost every facet of operations – is also pursuing ill-advised and overly prescriptive new regulations. This includes a proposed regulation that would mandate railroads to install and implement electronically controlled pneumatic (ECP) brakes. Railroads have tested and even used the technology – which would cost billions of dollars – and found them unreliable.[17] Reports from the National Academy of Sciences and the Government Accountability Office show that Department of Transportation data, and therefore the FRA's case to mandate ECP brake use, is highly suspect.[18]

In addition, the FRA in 2016 proposed a regulation that would force railroads to operate all trains with at least two crew members in perpetuity. The measure, which even the FRA admits is unsupported by data showing a need for such a regulation, would increase railroad operational costs and, ultimately, consumer prices.[19] In terms of quantitative evidence to suggest any safety shortfalls, there is nothing to support these rules. But most importantly, the

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[15] "Review of Commodity, Boxcar, and TOFC/COFC Exemptions," STB, Docket No, EP 704-1, March 23, 2016, https://www.stb.gov/Decisions/readingroom.nsf/WEBUNID/A0FA1A10A9B1553785257F7F006A6AB9?OpenDocument.

[16] "Railroad Revenue Adequacy," STB, Docket No. EP 772, April 1, 2014, https://www.stb.gov/Decisions/readingroom.nsf/WEBUNID/F808D9F1F151F6EC85257CAE005ABDA2?OpenDocument.

[17] "Train Braking: DOTs Rulemaking on Electronically Controlled Pneumatic Brakes Could Benefit from Additional Data and Transparency," GAO-17-122, October 12, 2016, http://www.gao.gov/products/GAO-17-122.

[18] Ibid.

[19] "Train Crew Staffing," Federal Railroad Administration, FRA-2014-0033, Washington, DC, March 15, 2016, https://www.federalregister.gov/documents/2016/03/15/2016-05553/train-crew-staffing.

regulation is emblematic of a flawed regulatory system that can hijack reasonable policy. One consequence is that future improvements and innovations by an industry can be stopped at a tremendous cost before they can even be tested.

In total, these new and potential regulations bring unnecessary oversight and run counter to the regulatory reforms and resulting successes of past decades. These new and proposed rules will affect costs, efficient routes and commodities shipped, and they impose additional labor costs and create inefficiencies. The net result of these regulations will mean less investment and higher transportation costs – the very things that deregulation corrected many years ago. In the end, consumers will be the loser, as higher transportation costs creep into the cost of retail products.

What Reforms Should Look Like

Regulators need to resist the temptation to regulate for the sake of regulating. In almost 40 years, competition within the rail industry has evolved into interindustry competition among trains, trucks, ship barges and airplanes, including innovated intermodal competition. With increased rivalry and market contestability, increased regulations are counterproductive, costly and unnecessary. These regulations would not help consumers and would ultimately increase consumer prices.

In summary, Congress should immediately take steps to limit this regulatory creep. If there is one thing we have learned from the past, decreasing regulations was a success, and regulators need to avoid undoing this success for the sake of consumer welfare.