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For much of the 20th century, federal regulators tightly controlled the railroad industry, including rail investment and prices. By the 1970s, several major carriers were on the verge of bankruptcy, and lawmakers, facing the prospect of costly bailouts, acted boldly and repealed onerous regulations, allowing market forces to re-energize the industry. In the 40+ years since, industry productivity has more than doubled, investment has surged, and inflation-adjusted rail rates have decreased. However, the success of the industry is now in jeopardy, as regulators, swayed by vested interest groups, ponder new rules that would impact railroad profitability and increase price regulation. This study reviews four of the proposed rules by the Surface Transportation Board (STB) and discusses rent-seeking as a major driving factor in the resurgence of regulations. We find no evidence of a market failure to justify reregulating the industry and reversing the gains made in the last four decades. We do, however, find that imposition of these rules will cause irreparable harm to capital formation, the environment, job growth, and consumer welfare.

Regulatory Reforms of 1980s Worked

Over 130 years ago, the Interstate Commerce Commission (ICC) was tasked with regulating railroad carriers, in part, to ensure fair rates.¹ In the years that followed, regulations mounted – establishing strict controls over rail routes, influencing rail costs and investments, and setting shipping prices. Spurred by Congressional legislation that culminated with the Federal-Aid Highway Act,² trucking began to erode significant freight volumes. The Interstate Highway System made trucking a formidable competitor against rail, which had inflexible prices

* For more information American Consumer Institute Center for Citizen Research, visit www.TheAmericanConsumer.org.

¹ Steve Pociask, “Derailed Benefits: How the Resurgence of STB Regulations Will Impact Consumers,” *American Consumer Institute*, October 24, 2018, <https://www.theamericanconsumer.org/wp-content/uploads/2018/10/Railroad-Regulation-Final.pdf>.

² “Highway History: The Greatest Decade 1956-1966,” U.S. Department of Transportation, Federal Highway Administration, updated June 27, 2017, <https://www.fhwa.dot.gov/infrastructure/50interstate.cfm>.

and was required by regulation to maintain unprofitable lines. By the 1970s, the financial viability of the rail industry had become so threatened that several large carriers went bankrupt, and industry profits disappeared.³

Faced with costly bailouts and even the possibility of nationalizing the rail industry, Congress moved ahead to reduce ICC regulations. This allowed for the abandonment of unprofitable routes and encouraged flexible and differential pricing. In just a few years and despite increased competition, the industry rebounded with an unprecedented recovery that included increased freight volumes, significantly improved productivity, and decreased rates for shippers in inflation-adjusted terms. Profits rose, and consumer welfare increased by approximately \$10 billion in annual benefits because of these reforms.⁴

The railroad industry's financial rebound coincided with increased investment and continued maintenance of the rail networks. The turnaround was so astounding that, by the mid-1990s, the ICC was abolished. Some of its remaining regulatory functions were transferred to a new regulatory body, *the Surface Transportation Board* (STB).

History shows that ending onerous rail regulations was an indisputable success. The imposition of regulatory reforms proved that railroads could be self-sufficient in a more competitive market and that less regulation of the rail industry was better than more.

Regulatory Creep

In recent years, however, there has been a resurgence of STB rulemaking proceedings focused on (seven) Class I railroads. In some ways, these proceedings bring back many of the same onerous regulatory burdens that once plagued the railroad prior to the 1980s. Among

³ From 1962 to 1978, industry returns on investment averaged only 2.4%. For a more complete discussion and references to railroad deregulation and the resulting market outcomes, see "Regulating Railroads is the Wrong Track for Consumers," The American Consumer Institute, 2017, at <http://www.theamericanconsumer.org/wp-content/uploads/2017/03/RR-CG-Final.pdf>.

⁴ Steve Pociask, "Smart Rail Regulations Protect Consumers," *Morning Consult*, April 5, 2017, <https://morningconsult.com/opinions/smart-rail-regulations-protect-consumers/>.

these proceedings is the Final Offer Rate Review (EP 755), which seeks to modify the current procedure for settling a rate dispute between a railroad carrier and a shipper.

If adopted, the Final Offer Rate Review gives STB only a binary choice: to either accept a railroad's final rate offer or accept a shipper's final rate offer. While the proposal considers only two possible solutions for a settlement, the parties offer could be any price along a continuous array of choices. Since the market rate is only a single point along the continuum, any binary choice would almost always be wrong. As a result, the STB may select a shipping rate that is too low or even predatory; or it may opt for a rate that is too high, effectively price gouging shippers. Shippers would be incentivized to challenge rates knowing that a binary solution could occasionally be settled in their favor. As a result, this proposal, if adopted, would encourage more rate disputes and increase the likelihood of STB mandates to lower rates.

The proposal, if adopted, would also permit disputed prices to be subject to regulatory error or ideological prejudice. Hence, if adopted, the increased flexibility afforded the STB would allow it to become less objective and more subjective, depending on the composition of the Commission or its ideology at the time of the dispute.

While the proposed rulemaking offers modification to the dispute settlement process, the actual number of disputes between shippers and rail is low, and it currently substantially less compared to the previous decade. For example, between 2010 and 2019, there were only three instances where a shipper complaint led to the STB finding that a particular railroad rate was unreasonable; and during the decade before, there were seven such decisions.⁵ From these facts, it is not clear what problem the STB is trying to solve.

In a second regulatory proceeding (EP 756), the STB is looking at whether to relax rules so that a complainer (a shipper) can more easily establish a *prima facie* case that it is served by a market dominant railroad carrier.⁶ If a route is more likely to be deemed dominant, then the

⁵The history of STB's rate cases are available online at <https://prod.stb.gov/wp-content/uploads/Rate-Case-List-11-19-2019.pdf> (downloaded January 28, 2020).

⁶ See *Bell Atlantic Corp. v. Twombly*, 550 U.S. 554 (2007); *Swierkiewicz v. Sorema N.A.*, 534 U.S. 506 (2002); and *Hernandez v. New York*, 500 US 352 (1991).

STB has more regulatory authority over the rate setting process, which again may lead to more rate disputes and the potentially for more rate decreases.

A third rulemaking proceeding, EP 761, deals with whether Class I railroads are “revenue adequate.” The Congressional reforms that took place 40 years ago enabled the railroads to make sufficient earnings to cover their operations, attract capital, and receive a reasonable return on investment. A railroad is deemed to be revenue adequate when its percent return on invested capital meets or exceeds the industry’s percent cost of capital. Essentially, the cost of capital establishes a “floor” for adequate returns on investment. Recently, the STB issued the EP 761 notice on whether the revenue adequacy test should include a “cap” on the rate of return. If this rule were put in place and returns on investment were found to be higher than an established cap, this could result in mandatory price decreases, which would tamp down earnings and investments compared to today’s rules. Essentially, the implications of this rule would limit rail earnings.

A fourth proposed rule, EP 664, Sub-No. 4, would revise the methodology used in determining the cost of capital. If such revisions result in lower estimates of the cost of capital then, in combination with a revenue adequacy cap, the prescribed rates of return for a railroad would be further reduced, and lower prices would be again mandated. In this case, price reductions would be solely the result of a definitional change, not endogenous to any operational changes in the performance of a Class I railroad.

In sum, the combination of proposed EP 755 and EP 756 proceedings would negatively impact prices, while the combination of EP 761 and EP 664 proposals would bring downward pressure on earnings, which would further reduce prices and hinder future investment.

While there are several other major rulemaking proceedings, the effects of these four regulatory proceedings discussed here appear to be aimed at lowering railroad earnings and prices.

The implementation of these proposed regulations would unquestionably have negative repercussions and increase market uncertainty on the investment decision-making of Class I

railroad carriers. As such, these rulemaking proceedings, if promulgated, would increase the STB's control over railroad pricing and earnings, which would give regulators the authority to mimic much of the same onerous regulations that existed pre-1980, and without Congressional authority. In the presence of growing intermodal competition, it is reasonable to expect comparative market outcomes and negative consequences to impact consumer welfare in a manner similar to what occurred more than forty years ago.

The Problem: Market Failure vs. Regulatory Failure

Regulations have been rationalized as efforts to address market failures. Externalities, market power, imperfect information, and public goods are the main culprits identified by economists as sources underlying market failures.⁷ However, research shows that when looking at elements of the structure of railroad markets, conduct, and performance, there is no clear market failure that would justify increasing earnings and price regulation.⁸

Rail receives significant intermodal competition, so much that a need for regulation based on market conduct is even less compelling.⁹ The most significant element is, of course, market performance. However, to date, we see healthy industry investment, modest profits, and stable pricing.

In terms of profits, empirical evidence demonstrates that railroads are not more profitable than most other industries. For example, looking at a 10-year period of financial results, industry profitability in terms of “over-adequacy” – that is, the weighted average cost of capital minus return on invested capital – railroads would appear to fall short of revenue adequacy. At the same time, other industries, except electric and gas utilities, would appear to

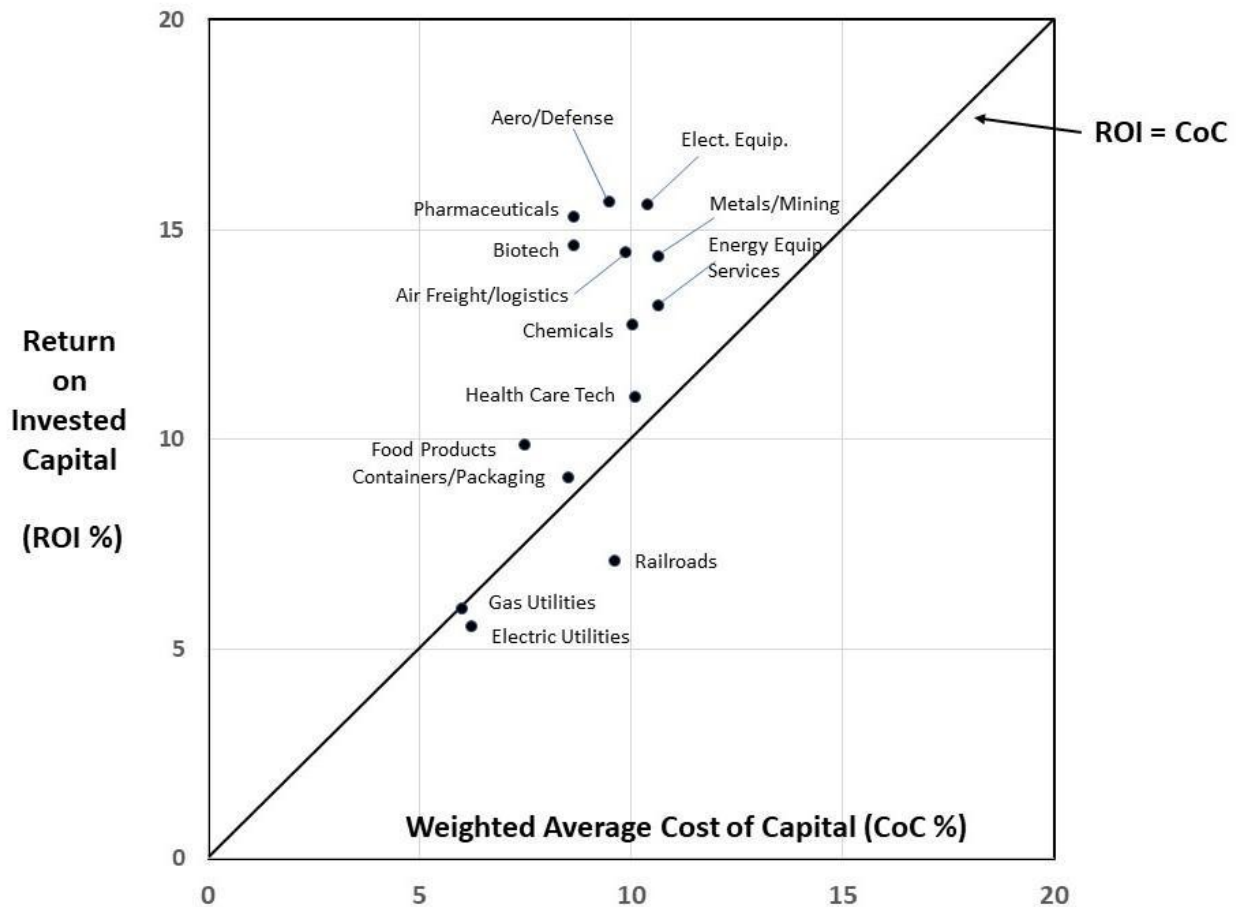
⁷ Richard O. Zerbo, Economic Efficiency in Law and Economics, especially chapter 7, “The Failure of Market Failure”, Edgar Elgar (pub) Northampton, MA, 2001.

⁸ This was the conclusion of a study on rail structure, conduct and performance, See Steve Pociask, “Derailed Benefits: How the Resurgence of STB Regulations Will Impact Consumers,” American Consumer Institute, October 24, 2018, <https://www.theamericanconsumer.org/wp-content/uploads/2018/10/Railroad-Regulation-Final.pdf>.

⁹ Ibid.

be over-adequate.¹⁰ The results, depicted in Figure 1, suggests that using the STB’s definition of acceptable returns on capital would find over-adequacy to be “the norm across industries.”¹¹ As such, there is no compelling evidence of supernormal profits, the exertion of market power, nor market failure that would justify a regulatory remedy.

Figure 1: By STB’s Definition, Most Industries are Over-Adequate (10-Year Averages, 2004 to 2013)



Source: Adapted from Joseph P. Kalt and Raymond Atkins, “Hearing on Railroad Revenue Adequacy, Docket No. EP 761 & 722, December 12, 2019, citing Parthenon and Bloomberg data.

¹⁰ See Joseph P. Kalt and Raymond Atkins, “Hearing on Railroad Revenue Adequacy,” Before the Surface Transportation Board, Docket No. EP761 & 772, On Behalf of Association of Railroads, December 12, 2019, citing Parthenon analysis and Bloomberg data. Hearing memo available here: <https://prod.stb.gov/news-communications/transcripts-statements/>.

¹¹ Ibid.

Although markets may sometimes be imperfect, so too are government regulatory processes. Examples of government regulation infirmities include regulatory lag, regulatory creep, asymmetric and imperfect information, regulatory capture by vested interest groups (rent-seeking), the absence of regulatory commitment, and the inability of policymakers to forecast regulatory impacts in a dynamic market. Given that bureaucracies might not have the same incentives for efficiency, cost minimization, and welfare maximization as private markets do, their services often come at twice the cost.¹²

Fixing market failure is like shooting at a moving target. Markets solve imperfections through competition and private contracts. Regulations move at glacier-like speed to correct imperfections and are slow to expire when outmoded, in the face of changing market rivalry, changes in consumer preferences, evolving technologies, or maturing market strategies. Thus, regulatory errors can have significant impacts on markets. As Joseph Stiglitz, Nobel prize-winner and former Chairman of the President's Council of Economic Advisors emphasized a decade ago:

*"Anyone who has watched the U.S. government in the last seven years is well aware not only of the possibility of government failure but also of its reality. In some cases, it is a matter of incompetence, in others of corruption, in still others it is a result of ideological commitments that preclude taking appropriate actions...Government programs can be subverted."*¹³

Even in the presence of imperfect markets, government intervention is not a necessary and sufficient condition. Regulations should only be imposed if they can outperform imperfect markets. Yet, these regulatory proceedings offer no empirical evidence showing the net social benefits of these proposed regulations over the *status quo*.

¹² See K. Hayes and L.L. Wood, "Utility Maximizing Bureaucrats: The Bureaucratic Point of View," *Public Choice*, Vol. 82, Issue 1-2, pp. 69-83, January, 1995; and James T. Bennett and Manuel H. Johnson, *Better Government at Half the Price: Private Production of Public Services*, Jameson Books, Inc., 1982.

¹³ Joseph E. Stiglitz, "Government and Markets: Toward a New Theory of Regulation", [Government Failure vs. Market Failure: Principles of Regulation](#); and Edward Balleisen and David Moss, Eds., *The Tobin Project*, available at the Cambridge University Press, 2009, p. 17, <https://www.cambridge.org/core/books/government-and-markets/government-failure-vs-market-failure-principles-of-regulation/D66D50EFD53E5823A8CBE2C48B8085D1>.

Given that the regulatory reforms of the 1970s-80s yielded an annual \$10 billion annual increase in consumer welfare, it would be cogent that reinstating these regulations would significantly decrease consumer welfare, at least long term. Additionally, it is yet not clear how transferring surplus between buyers and sellers would increase social welfare. Thus, we can only speculate what problem these regulations seek to remedy.

Resurgence of Regulations Reflects Rent-Seeking

While there is an idyllic notion that legislative and regulatory bodies are comprised of altruistic government officials that act only in the interest of public well-being, public choice theory presents a more pragmatic viewpoint that the decision-making of these government bodies is often swayed by self-interests and private interests, including special interest groups, lobbyists, or other vested interests – all at the risk of sacrificing social welfare.¹⁴

For example, some special interest groups may lobby regulators for a policy that concentrates benefits to themselves, while spreading the costs of these policies more widely across society. The effect of such policies, while benefiting a few and providing no net benefit to society, because it has a small financial impact on others, goes largely unnoticed. Similarly, companies may expend extensive time and resources lobbying for policies that transfer wealth from other companies to themselves, while creating no added wealth to society as a whole. These activities are referred to as *rent-seeking*, and they provide a rational explanation for why legislative and regulatory proposals by groups with vested interests may not act in the public interest and may do more harm than good to society. Gordon Tullock and Nobel Prize economist James Buchanan describe it this way:

“The organized pressure group thus arises because differential advantages are expected to be secured through the political process, and, in turn, differential

¹⁴ See James M. Buchanan and Robert D. Tollison, eds. *The Theory of public choice—II*, Vol. 2, University of Michigan Press, 1984; and Robert D. Tollison, "Public choice and legislation." *Virginia Law Review*, Vol. 74, 1988, p. 339.

advantages for particular groups are produced because of the existence of organized activity.”¹⁵

As for the aforementioned rulemaking proceedings, one group stands out as a major proponent for increasing the regulation of railroad carriers, namely – the American Chemistry Council (ACC).¹⁶ The group – predominantly representing companies that ship goods, often using rail – actively engaged in lobbying for these regulations. Because all four proceedings would put downward pressure on rail prices, there would be a short-term benefit to shippers that rely on rail for transportation. This all begs the question: do shippers really need this help?

Are Shippers in Need of Financial Assistance?

As previously stated, the proposed STB regulations, if approved, would lead to lower earnings and prices for Class I railroads. Because these regulations would effectively transfer producer welfare from railroads to shippers, it would result in an exclusive financial benefit for shippers. This raises the question of whether these regulations are needed at all to assist shippers financially.

As evidenced by shippers’ superior returns on invested capital compared to their cost of capital, those advocating to regulate the pricing of railroads enjoy a much better financial performance. Using STB’s own method to calculate revenue adequacy (median return on investment minus cost of capital), a recent analysis compared Class I railroad carriers to ACC members in the S&P 500, and found that rail carriers were just below adequacy, while ACC members were extraordinarily profitable.¹⁷

¹⁵ James M. Buchanan and Gordon Tullock, “The Calculus of Consent: Logical Foundations of Constitutional Democracy,” Ann Arbor Paperback, University of Michigan, 1965.

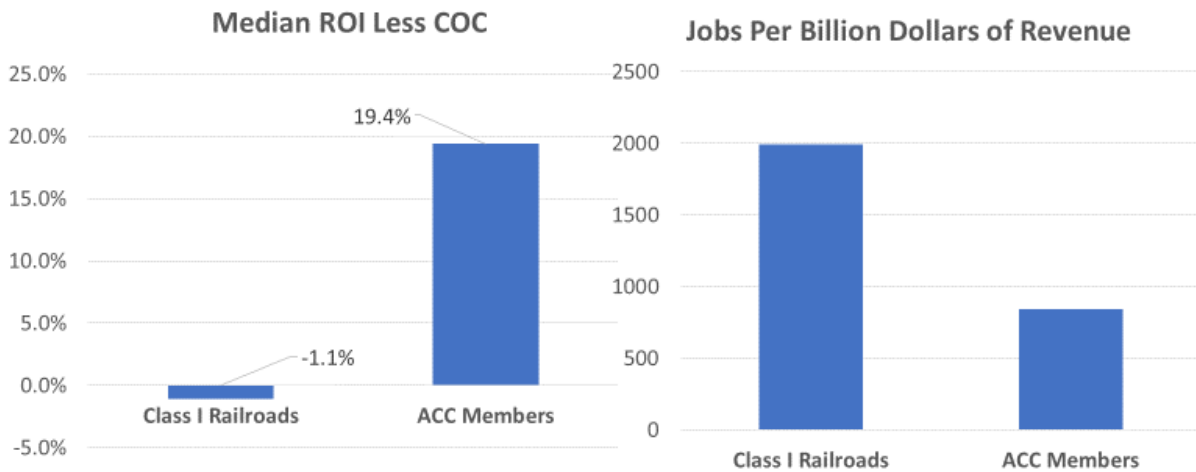
¹⁶ Joanna Marsh, “Railroads, Shippers Grapple over Revenue Adequacy,” *FreightWaves*, December 13, 2019, <https://www.freightwaves.com/news/railroads-shippers-grapple-over-revenue-adequacy>.

¹⁷ See Joseph P. Kalt and Raymond Atkins, “Hearing on Railroad Revenue Adequacy,” *Before the Surface Transportation Board, Docket No. EP761 & 772, On Behalf of Association of Railroads, December 12, 2019, citing Parthenon analysis and Bloomberg data.*

We separately looked at the financial data for the same set of ACC companies and Class I railroad carriers and found that the railroads produced twice the cash flow per dollar of revenue and that higher cash flow produced a higher percent of investment.¹⁸ In other words, there is no evidence that shippers, collectively, are converting their superior profits into additional investment. Moreover, there is no evidence that these firms utilize more labor. Specifically, we found that railroads create more than twice as many jobs per dollar of revenue than shippers.

Figure 2 shows the stark contrasting results. From a financial perspective, there is no need for shippers to be subsidized by railroads, and that such a transfer would lead to fewer jobs and less railroad investment. As revenue decreases, workers are hurt by these regulations.

Figure 2: ACC Members Produce More Profits and Fewer Jobs Than Class I Railroads



Source (Left): Kalt and Atkins, 2019, citing Murphy and Zmijewski

Source (Right): Yahoo Finance and STB Filings, downloaded 01/28/2020

¹⁸ Financial data was collected from Yahoo Finance and the STB’s RE&I reports, as well as the Report on Railroad Employees, Service, and Compensation. All data were downloaded on January 28, 2020 and were for the year 2018. For more information, see www.STB.gov and <https://finance.yahoo.com/>.

Overall, comparing shippers and Class I railroad earnings, we find that the ACC members enjoy superior profits. Thus, by all fair reckoning, those well-informed should be left to wonder why and how the public interest would be served by imposing government controls on the prices and services for the benefit of mostly profitable, giant corporations? Ironically, some of the ACC members, specifically energy producers and pharmaceutical manufacturers, are on record as opposing price regulations on their own products.

Given a lack of evidence supporting the need for regulatory protections, and the evident profitability of shippers, the need for an increase in regulations seems to be absent of any empirical support. While rent-seeking may make sense for shippers, it does not serve the public interest, and the STB should resist the temptation to impose these onerous regulations on railroad carriers.

Long Term Implications on Capital Investments

Lower rates for shippers will provide some short-term benefits for shippers. However, long-term impacts could be harmful to shippers, workers, consumers, and the environment. This is because lower earnings will lead to less investment by the railroads. That, in turn, will make railroads less responsive to competition, which would affect the operational efficiency of railroads. In other words, there will be less revenue for the same quantity of productive inputs.

This point was corroborated by an econometric analysis conducted by Ford, which finds a statistically strong relationship between rail industry revenues and its returns on infrastructure investment, and concludes that the imposition of these regulations will adversely impact rail investment.¹⁹ Simply put, falling revenue will force carriers to tamp down capital investments and operating expenses. That, overtime, will likely impact volumes of business and, therefore, revenues, which will lead to further cuts in spending, and so on. The longer-term impact of this

¹⁹ George S. Ford, "Infrastructure Investment in the Railroad Industry: An Econometric Analysis," Phoenix Center for Advanced Legal & Economic Public Policy Studies, December 9, 2019, <https://www.phoenix-center.org/perspectives/Perspective19-07Final.pdf>.

downward spiral will undermine rail infrastructure and produce opportunities for the trucking industry.

1. Divestment Impacts on Consumers and Shippers

Capital expenditures on railroad equipment have very long lives, and the decision to invest is significantly affected by uncertainty. Regulatory changes can add, delay, or create ambiguity and a lack transparency; lead to rent-seeking and gaming by competitors; and take away opportunities of value. All of these sources of risk can be found in the STB's current rulemaking.

Skeptics of the existence of regulatory uncertainty and the effects of financial risk should consider the glacial pace of regulatory decision-making, where a single regulatory decision can lag many years, and administrative procedure requirements can dictate long pleading cycles, all contributing to added costs and delays in review and analysis. Regulatory history establishes that the greater the economic stakes are, the greater the financial or political strengths of stakeholders (rent-seekers) are.

Investment managers and capital budgeters within firms, and financial market investors alike, will regard all this as regulatory uncertainty undermining efforts to forecast operating costs and revenues, thereby increasing investment risk, and raising capital costs. Microeconomic theory suggests that as production cost increases, quantity (and quality) produced decreases and consumer welfare decreases.

Higher regulatory costs and risks will mean that rail carriers will invest less and that consumers will pay more for less. Therefore, while rail carriers are worse off, so are consumers. And as mentioned earlier, the transfer of producer welfare from railroad carriers to shippers will undermine the basic infrastructure that provides consumer goods, it will increase the earnings of shippers that have (collectively) superior profits, and it will lead to fewer jobs for workers.

2. Environmental Impacts

As rail investment falls, demand for trucking will increase. This, however, raises a number of environmental issues. America's roads and highways are becoming more congested and structurally deficient. In 2014 alone, federal, state, and local governments spent \$165 billion to build, operate, and maintain highways.²⁰ Past and current investments have proven to be insufficient to keep up with a deteriorating system, much less to finance the upgrades and expansions needed to accommodate the growing demand for surface transportation. As of 2017, the U.S. had an \$836 billion backlog of highway and bridge capital needs.²¹ In some states, nearly three in four roads are in poor or mediocre condition.²² Nationwide, the annual costs of vehicle expenses were estimated to be an additional \$66.6 billion in 2013, due to driving on roads in need of repair.²³

The congestion, added pollution, and an enormous amount of heavy trucking provides a stark example of how social costs are not aligned with private costs:

“Engineers estimate that a fully loaded truck – a five-axle rig weighing 80,000 pounds, the interstate maximum – causes more damage to a highway than 5,000 cars. Some road planners say that the toll is even higher, that it would take close to 10,000 cars to equal the damage caused by one heavy truck. When the trucks are overloaded, as quite a few of them are, the damage is exponentially worse. Increasing a truck's weight to 90,000 pounds results in a 42 percent increase in road wear. Pavement designed to last 20 years wears out in seven.”²⁴

²⁰ Chad Shirley, “The Status of the Highway Trust Fund and Options for Paying for Highway Spending,” Congressional Budget Office, June 17, 2015, http://www.cbo.gov/sites/default/files/114th-congress-2015-2016/reports/50298TransportationTestimony_1.pdf.

²¹ “2017 Infrastructure Report Card,” American Society of Civil Engineers, 2017, <https://www.infrastructurereportcard.org/wp-content/uploads/2017/01/Roads-Final.pdf>.

²² “U.S. Road and Bridge Data by State,” U.S. Department of Transportation, updated October 13, 2013, <https://www.transportation.gov/briefing-room/dot-fact-sheets-highlight-grim-state-us-roads-and-bridges>.

²³ Ibid.

²⁴ Zach Patton, “Too Big for The Road,” *Governing Magazine*, July 2007, <http://www.governing.com/topics/transportation-infrastructure/Too-Big-The-Road.html>.

Compared to trains, trucks create three times more pollution per ton.²⁵ The bottom line is that these regulations will negatively impact shippers, consumers, workers, taxpayers, and the environment. As these regulations take hold, the rail market's cashflow would suffer serious consequences. Shippers will need to rely more on trucking at a cost estimated to be as high as \$1.4 trillion, and taxpayers will incur increased maintenance costs for highway and bridge improvements from the wear and tear of more trucking.²⁶ Society will be much worse off.

Conclusions

At the behest of a few interest groups, the STB is considering a series of regulations that would increase the STB's control over railroad pricing and earnings. This, however, threatens to reintroduce much of the same onerous regulations that existed pre-1980, as well as the negative repercussions that occurred at that time. Regulation is not costless and forcing rules that disregard historical evidence and economic theory would fail to benefit consumers and negatively impact the environment and the economy.

This study shows that the proposed STB regulations fall well outside mainstream economic theory and fall well short of demonstrating benefits to consumers. Since there is no evidence provided in the proposed regulatory proceedings that these regulations would lead social welfare benefits above the *status quo*, the STB should resist the urge to overregulate and avoid the consequences of regulatory failure.

In the long term, if these regulations were adopted, we will find shippers, taxpayers, the environment, consumers, workers, and the general economy worse off. In the end, policymakers should rely on empirical evidence and the lessons of history.

²⁵ According to a University of Wisconsin-Madison study, see "Freight Trains a Clear Winner Over Trucks in CO2 Emissions Stakes," Sci GoGo, December 12, 2011. Also see Bay Rail Alliance, citing California High-Speed Train Final Program EIR/EIS, CSX estimates, and a 1984 AASHTO Report, at http://www.bayrailalliance.org/why_trains.

²⁶ Marc Scribner, "Bait and Reciprocal Switch: Forced Access Regulation Threatens the Rail Renaissance," Competitive Enterprise Institute, *OnPoint*, No. 190, March 24, 2014, p. 2.