



# How “Reasonable” Restrictions Become Unreasonable

Steve Pociask and Justin Leventhal\*

## Executive Summary

Recent legislative and executive proposals are attempting to impose public utility-style regulations on the U.S. freight rail system. These proposals are akin to the outdated and repealed Interstate Commerce Commission’s regulations that once led to numerous bankruptcies for freight rail lines over 40 years ago. While some problems may exist with the current common carrier regulations that could be addressed, recent proposals seem directionally to be onerous and extreme, thereby representing a step back to the failed policies in the past and away from improving the U.S. transportation sector.

In June of 2023, one bill was introduced that would expand STB’s authority to manage freight rail operations including both employment and equipment as well as requiring reasonable, timely, efficient and reliable service without defining these terms in the context of freight shipping.<sup>1</sup> This bill is likely to lead to higher prices for goods shipped, encourage rent-seeking by some shippers, and reinstate onerous regulations that were removed some forty years ago.<sup>2</sup>

In addition, recent White House executive orders, as well as calls for reform by the industry’s economic regulator – the Surface Transportation Board (STB) – have spawned legislative debate for change, which are now actively being considered. Many of the proposals suggested so far are based on 19<sup>th</sup> century assumptions that freight rail providers operate primarily as monopolies. However, due to intermodal rivalry and ongoing disruptions in the freight economy, rail is not the dominant method of modern freight transportation, let alone a monopoly. In terms of freight ton miles, the rail freight sector supplies 27 percent of the total interstate transportation demand and operates with several regulatory backstops that protect rail customers from the potential of market abuse.<sup>3</sup>

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<sup>1</sup> “S.2071 - A bill to amend section 11101 of title 49, United States Code, to ensure that rail carriers provide transportation or service in a manner that fulfills the shipper’s reasonable service requirements,” sponsored by Senator Tammy Baldwin, see <https://www.congress.gov/bill/118th-congress/senate-bill/2071>.

<sup>2</sup> “Issue Spotlight: Common Carrier Obligations for Rail Carriers,” International Center for Law and Economics, March 16, 2023, [https://laweconcenter.org/spotlights/issue-spotlight-common-carrier-obligations-for-rail-carriers/?doing\\_wp\\_cron=1687455250.4940888881683349609375](https://laweconcenter.org/spotlights/issue-spotlight-common-carrier-obligations-for-rail-carriers/?doing_wp_cron=1687455250.4940888881683349609375).

<sup>3</sup> “U.S. Ton Miles of Freight,” Bureau of Transportation Statistics, accessed May 23, 2023, <https://www.bts.gov/content/us-ton-miles-freight>.

Despite ample competition, some large industrial stakeholders and policymakers are seeking to expand the current common carrier standard that regulates today's railroads. Specifically, many have called on the STB to have more control over shipping rates, service delivery standards, labor practices, oversight of equipment, reciprocal switching, and revenue adequacy, to name a few. These changes to the current common carrier system would shift railroads to operate subject to public utility-style regulations, but without necessarily a guaranteed rate of return otherwise afforded to traditional utilities.

Many of these proposed regulatory changes would unquestionably create operational inefficiencies, and raise service costs, which would lead to higher freight transportation rates and/or financial instability for rail operators. If this were to occur, many of those who currently use rail as a method of transporting goods may choose to use less costly and more widely available alternatives, such as trucking. As a result, not only would the price of consumer and business goods be negatively affected, but it would also lead to adverse effects on the environment, increase the burden on the taxpayer to maintain roads and infrastructure improvements necessary for increased truck-based transportation, as well as decrease investment in the freight rail system. Essentially, excessive and onerous government intervention will squeeze out the private sector operations and rail investment and could risk the demise of an effective competitive alternative to trucking.

Instead of trying to set artificially lower prices and impact services and operations of freight rail companies, policymakers should first consider the benefits of intermodal competition and not interfere with market incentives that already exist and that drive operational efficiency. At a minimum, policymakers should avoid changes to the common carrier obligation that would move rail closer to operating like a public utility. For more meaningful reform, policymakers should consider lessening or eliminating the current common carrier obligation, while providing for regulatory guardrails to protect public safety and encourage competitive investment.

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## Introduction

Recent proposals from the Administration and the U.S. Congress have called for onerous regulations to be imposed on the freight rail industry, including the establishment of a public utility-style price setting regime. Are these regulations needed to improve market performance and conduct, and would they work? This hypothesis can be tested by looking back some forty years ago when similar rail regulations were in place. Looking back in time, a sound judgement can be made as to whether reinstating these regulations would benefit consumers or not.

Another approach is to consider the extent to which a market failure – the presence of monopoly power – is perceived to have existed a century ago, which may have justified some form of regulatory intervention at the time. The question then becomes -- to what extent do these supposed risks from market failure exist today? Have these risks intensified or dissipated today, compared to years gone by? Said differently, if market structure (concentration) was perceived as a major risk a century ago, what is the state of competition and intermodal rivalry today? If market competition has increased more recently, then would these proposed regulations be entirely unnecessary and potentially be a suboptimal policy solution?

To answer these questions, the next section reviews the history of regulation of the U.S. freight rail industry from its beginning nearly 150 years ago to the regulatory rate reforms that took place some 40 years ago. This paper will show how the market has responded to these regulatory changes.

## A Brief History of Railroad Price Regulation in the U.S.

Regulation of the freight rail system in the U.S. began with the Interstate Commerce Commission (ICC) in 1887. Founded by the Interstate Commerce Act, it marks the first time in U.S. history that the federal government directly regulated an industry.<sup>4</sup> The motivation at the time was to prevent railroad cartels from setting monopoly prices for short and long-haul services. Despite the intentions of the Act, in the years after its passage, cartels became even more successful.<sup>5</sup> Collusion only broke down when demand for rail services fell in the depression of 1893 to 1896.

With the passage of the Sherman Act, collusion between railroad companies became illegal, leading smaller railroad operators to merge together forming larger ones. The ICC's

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<sup>4</sup> “Interstate Commerce Act (1887),” National Archives, February 8, 2022, <https://www.archives.gov/milestone-documents/interstate-commerce-act>.

<sup>5</sup> Thomas Ulen, “The Market for Regulation: The ICC from 1887 to 1920,” *The American Economic Review*, May 1980, 306 – 310, <https://www.jstor.org/stable/1815487>.

power to regulate freight rail as a public utility was expanded several times throughout the 20<sup>th</sup> century. In 1906, the Hepburn Act allowed the ICC to cap rates and impose penalties for rebates.<sup>6</sup> This was followed by the Mann-Elkins Act in 1910, which allowed additional controls over rate setting.<sup>7</sup>

The Transportation Act of 1920 extended the ICC's power further to include setting minimum rates and dictating capital formation, including entry and exit from the industry, as well as the consolidation of firms.<sup>8</sup> Notably, the Transportation Act gave the ICC the power to set rates, provided that rail carriers were entitled to a fair rate of return on their embedded rate base (accumulative capital investment).

As the ICC regulations began to set artificially low prices for the rail freight transportation, rate of return regulations created market distortions that lead to gross operational inefficiencies and increases in service costs.<sup>9</sup> However, the ICC did not quite regulate rates of return like other public utilities, preferring to keep their finger on lower rates while promising fair returns:<sup>10</sup>

“Other regulatory agencies—the Federal Communications Commission, Civil Aeronautics Board, Federal Energy Regulatory Commission, and the state public utility commissions—and even the ICC itself in the motor carrier area have pursued rate of return regulation as the most logical approach to rate regulation. But in the case of railroads, the ICC has avoided any such approach. It is not that the commission has formulated some alternative theory of rate regulation for the industry; rather, its rate policies have simply been arbitrary and capricious.”

Even if rate of return regulations were properly managed to guarantee fair returns, the approach distorts efficiencies in competitive markets. Economists, Averch and Johnson, observed that rate of return regulations created poor incentives for companies because they encourage firms to increase investment as high as possible, even if the investment is not productive.<sup>11</sup>

<sup>6</sup> “Hepburn Rate Bill,” National Archives, July 22, 2019, <https://www.archives.gov/legislative/features/hepburn>.

<sup>7</sup> Peri Arnold, “William Taft: Domestic Affairs,” University of Virginia Miller Center, accessed April 8, 2023, <https://millercenter.org/president/taft/domestic-affairs>.

<sup>8</sup> Thomas Moore, “Surface Freight Transportation Deregulation,” U.S. Department of Transportation – Transportation Statistics Annual Report, 1995, <https://www.econlib.org/library/Enc/SurfaceFreightTransportationDeregulation.html>.

<sup>9</sup> Mark Levin and Bruce Stram, “Nursing the Railroads Back to Health,” *Regulation*, September/October 1981, page 29, [https://heinonline.org/hol-cgi-bin/get\\_pdf.cgi?handle=hein.journals/rcatorbg5&section=48](https://heinonline.org/hol-cgi-bin/get_pdf.cgi?handle=hein.journals/rcatorbg5&section=48).

<sup>10</sup> Mark Levin and Bruce Stram, “Nursing the Railroads Back to Health,” *Regulation*, September/October 1981, p. 29, [https://heinonline.org/hol-cgi-bin/get\\_pdf.cgi?handle=hein.journals/rcatorbg5&section=48](https://heinonline.org/hol-cgi-bin/get_pdf.cgi?handle=hein.journals/rcatorbg5&section=48).

<sup>11</sup> Harvey Averch and Leland Johnson, “Behavior of the Firm Under Regulatory Constraint,” *The American Economic Review*, December 1962, page 1052 – 1069, <https://www.jstor.org/stable/1812181>; and William Baumol and Alvin Klevorick, “Input Choices and Rate-of-Return Regulation: An Overview of the Discussion,” *The Bell Journal of Economics and Management Science*, Autumn 1970, page 162 – 190, <https://www.jstor.org/stable/3003179>.

This *Averch-Johnson Effect* is often referred to as “gold plating,” where companies are incentivized to invest more, since they are guaranteed a percent return on their embedded capital. For example, assume that a telephone company needs \$10 million in total investments to adequately serve a town of customers. If the telephone company is guaranteed a nine percent return on its accumulative capital, it could increase its profits by simply doubling its embedded base of capital to \$20 million. While the company’s operations are now grossly inefficient, because it spends so much more to serve the same number of customers, it has doubled its earnings.

In a monopoly market, consumer prices would need to increase in order to recover the higher levels of capital inputs. However, if facing competition, overcapitalization would lead to higher prices, which would lead to falling demand, as customers move to alternative providers. A decrease in customers will lead to a drop in profits below the guaranteed rate of return, which will require even higher prices and another drop in falling demand, and so on.

This was the dilemma that the freight rail industry faced decades ago, as the ICC preferred to keep prices artificially low and higher rates would likely erode demand. Eventually, many rail carriers found themselves facing low returns and numerous bankruptcies in the 1970s.<sup>12</sup> The fact that rail carriers were unable to raise prices without losing more profits is evidence that it was not a natural monopoly and it likely faced effective competition. The inability of rail carriers to raise costs above marginal cost, according to a standard economic measure, demonstrates zero market power.<sup>13</sup> That may have already been the case pre-1980.

Essentially, rate of return regulation created a “death spiral” for the freight rail system, which was only made worse by other burdensome ICC regulations. ICC’s public utility-style regulations forced rail companies into an uncompetitive position with other forms of freight transit. Rail companies had to maintain and run unprofitable rail lines, ignore supply and demand when setting shipping rates, ignore the length of a train’s route when setting prices, arbitrarily set different rates for different industries’ products, and ignore changes in technology and traffic flow.<sup>14</sup>

As the chart (below) shows, due to the combination of onerous regulations and the sharp increase in trucking competition, freight rail is no longer the dominant mode of

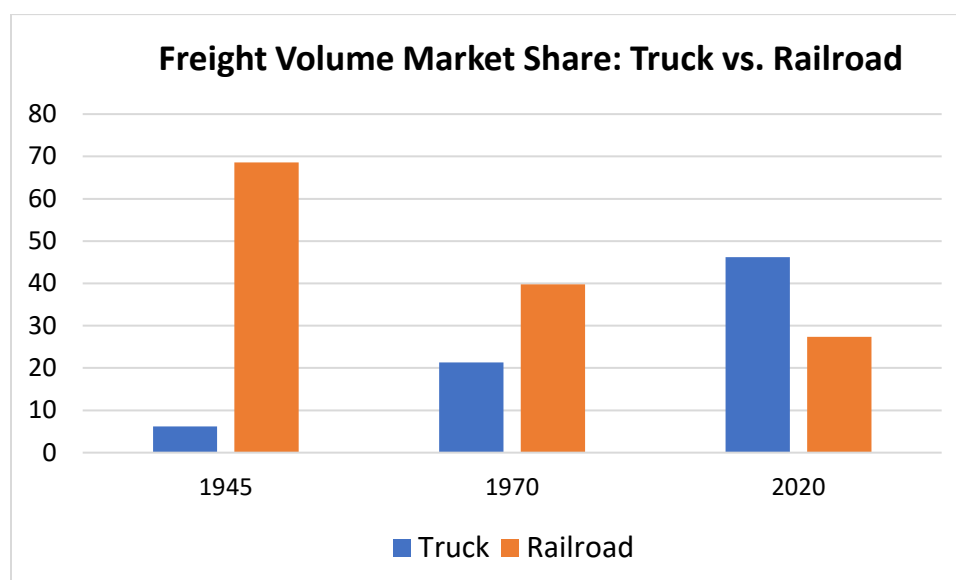
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<sup>12</sup> Adam Burns, “Abandoned Railroads: The Decline (1960’s and 1970’s),” *American-Rails*, March 1, 2023, <https://www.american-rails.com/1970s.html>.

<sup>13</sup> The Lerner curve measures the ability of a firm to raise prices above marginal cost. See, A. P. Lerner, “The Concept of Monopoly and the Measurement of Monopoly Power,” *The Review of Economic Studies*, 1934, Vol. 1:3, pp. 157–175.

<sup>14</sup> “A Short History of U.S. Freight Railroads,” Association of American Railroads, March 2023, <https://www.aar.org/wp-content/uploads/2020/08/AAR-Railroad-Short-History-Fact-Sheet.pdf>.

transportation.<sup>15</sup> Based on market structure, there is no obvious evidence of a market failure that would justify these onerous regulations.



Expensive and inefficient regulations, combined with competition from truck, barge, and air freight transport, sent enough railroads into bankruptcy to account for 21% of all rail line mileage in the U.S.<sup>16</sup> From the period 1962 to 1978, the industry’s average rate of return was just 2.4%.<sup>17</sup> Lacking funds, railroads couldn’t even maintain their existing privately-owned tracks, while facing a taxpayer-funded buildout of a massive publicly-owned interstate highway system that carried automobiles and trucks.

Faced with bankruptcies, Congress contemplated both nationalizing the railroads as well as significantly reducing onerous regulations. Congress chose deregulation and passed the Staggers Act, which drastically curtailed the burdensome restrictions and rules imposed by the ICC.<sup>18</sup> This legislation led to a realignment of investment in the freight rail industry. Railroads gained back control over their rates, routes, and asset management, giving freight rail companies the right incentives to align investments with demand and cut waste. As a result of

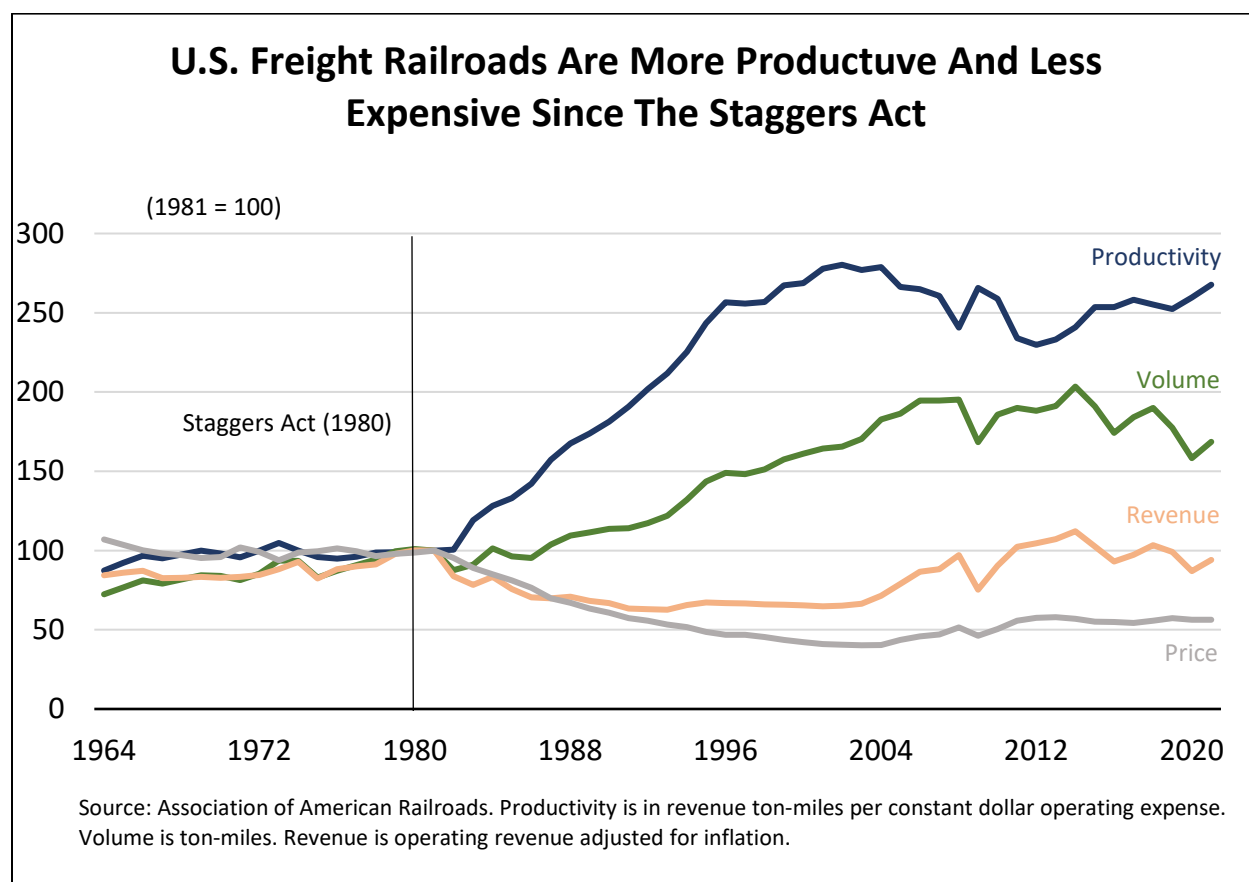
<sup>15</sup> “Historical Statistics of the United States: Colonial Times to 1970,” U.S. Department of Commerce, Bureau of the Census, part 2, Series Q 12-22, September 1975, p. 707; and “Transportation Statistics: Annual Report 2022,” U.S. Department of Transportation, Table 3.2. Also see The Bureau of Transportation Statistics for recent data at <https://www.bts.gov/>. Market shares are based on billions of ton miles.

<sup>16</sup> Ibid.

<sup>17</sup> 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, <http://www.theamericanconsumer.org/wp-content/uploads/2017/03/RR-CG-Final.pdf>.

<sup>18</sup> Joel Palley, “Impact of the Staggers Rail Act of 1980,” Federal Railroad Administration, March 2011, [https://railroads.dot.gov/sites/fra.dot.gov/files/fra\\_net/1645/STAGGER\\_%20RAIL\\_ACT\\_OF\\_1980\\_updated\\_31811.pdf](https://railroads.dot.gov/sites/fra.dot.gov/files/fra_net/1645/STAGGER_%20RAIL_ACT_OF_1980_updated_31811.pdf).

these regulatory reforms, the industry experienced a dramatic increase in productivity, while simultaneously lowering its prices, as the chart (below) summarizes. In short, due to this reduction in central control, rail rates have dropped 44% since 1981 and, despite the recent tragic derailments, rail accidents are now occurring at the lowest rate ever.<sup>19</sup> Reducing regulations saved the U.S. railroad system.



The concerns of monopolistic behavior that first drove the push for rail regulation have disappeared, as competition rose to compete with the rail system. Air and truck-based shipping were already competing with rail when the Airline Deregulation Act of 1978<sup>20</sup> and Motor Carrier Act of 1980<sup>21</sup> made airlines and trucks even more competitive in both short and long-

<sup>19</sup> "A Short History of U.S. Freight Railroads," Association of American Railroads, March 2023, <https://www.aar.org/wp-content/uploads/2020/08/AAR-Railroad-Short-History-Fact-Sheet.pdf>.

<sup>20</sup> Senator Howard Cannon, "S.2493 – Airline Deregulation Act," 95<sup>th</sup> Congress, February 6, 1978, <https://www.congress.gov/bill/95th-congress/senate-bill/2493>.

<sup>21</sup> Representative James Howard, "H.R.6418 – Motor Carrier Act of 1980," 96<sup>th</sup> Congress, February 5, 1980, <https://www.congress.gov/bill/96th-congress/house-bill/6418>.



haul transportation. Pipeline freight currently has a 18% market share.<sup>22</sup> Through intermodal competition, the justification for regulating prices for freight rail shipping disappeared. Since the deregulation of rail lines, productivity and consumer welfare has increased by over \$10 billion in annual benefits,<sup>23</sup> with some estimates suggesting even higher.<sup>24</sup>

## Current Railroad Price Regulation in the US

The ICC was dissolved and later replaced by the Surface Transportation Board (STB) in 1996.<sup>25</sup> The STB statutory authority is found in U.S. Code Title 49, Subtitle IV. More specifically, at the heart of the Board’s jurisdiction lies the common carrier obligation, found in § 11101.<sup>26</sup> This form of regulation attempts to correct the potential for market power in an industry by requiring service providers to accept all customers.<sup>27</sup> All railroads, including large railroads (Class 1), are required to “provide the transportation or service on reasonable request” of a customer and to provide similar rates for similar services. However, the term “reasonable” is not defined in the legislation.

In recent years, the STB has considered proposals to loosen definitional standards to consider freight rail operators as anticompetitive. Proposed regulations included an ability for the STB to compel operators to share (forced access) their facilities with their competitors — referred to as *reciprocal switching* — and considered rules to redefine revenue adequacy.<sup>28</sup> Forced reciprocal switching will increase rail operational expenses and investment and could lead to congestion and service delays. In the absence of a mutually agreed upon arrangement, disputes over rates will occur, which may open the door to price controls. Not only would these repercussions be a setback for industry productivity, but there is no evidence that forced access is a workable policy solution.

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<sup>22</sup> See fn. 13.

<sup>23</sup> Steve Pociask and Krisztina Pusok, “Misguided Proposals to Reimpose Onerous Rail Regulation Would Jeopardize the Public Good,” The American Consumer Institute, February 14, 2020, <https://www.theamericanconsumer.org/wp-content/uploads/2020/02/Final-Rail-Reg-Study.pdf>.

<sup>24</sup> Clifford Winston, “Economic Deregulation: Days of Reckoning for Microeconomists,” *Journal of Economic Literature*, September 1993, page 1263 – 1289, <https://www.jstor.org/stable/2728241>; C.C. Barnekov and A.N. Kleit, “The Efficiency Effects of Railroad Deregulation in the United States,” *International Journal of Transport Economics*, February 1990, page 21 – 36, <https://www.jstor.org/stable/42747087>.

<sup>25</sup> John Spsychalski, “From ICC to STB: Continuing Vestiges of US Surface Transport Regulation,” *Journal of Transport Economics and Policy*, January 1997, pages 131 – 136, <https://www.jstor.org/stable/20053723>.

<sup>26</sup> “Common Carrier Transportation, Service, and Rates,” U.S. Code, accessed April 10, 2023, Page 432, <https://www.govinfo.gov/content/pkg/USCODE-2021-title49/pdf/USCODE-2021-title49-subtitleIV-partA-chap111-subchapl-sec11101.pdf>.

<sup>27</sup> “Issue Spotlight: Common Carrier Obligations for Rail Carriers,” *International Center for Law & Economics*, March 16, 2023, <https://laweconcenter.org/spotlights/issue-spotlight-common-carrier-obligations-for-rail-carriers/>.

<sup>28</sup> Steve Pociask, “Derailed Benefits: How the Resurgence of STB Regulations Will Impact Consumers,” The American Consumer Institute, October 24, 2018.

## Open Access Did Not Work in the Regulated Telecommunications Sector

The concept of “open access” — where a regulated company is required to share its private investment with competitors is not new. For telecommunications providers, the concept became law under the Telecommunications Act of 1996.<sup>29</sup> The idea behind the rule was to allow facility-based telecommunications entrants, called *competitive local exchange companies* (CLECs), to build out their networks. To provide more complete coverage, they would be able to lease portions of facilities, called *unbundled network elements (UNEs)* and *line sharing*, from incumbent local exchange telephone companies (ILECs). When the Federal Communications Commission and state public utility commissions instituted their rules for open access, however, the regulators began to set the prices for leasing unbundled elements at predatorially low rates, effectively subsidizing CLECs at the expense of ILECs and ratepayers.

Over several years, over 100 CLECs took advantage of leasing unbundled elements, but few invested in their own networks, since the leasing rates were much lower than the actual costs to build. Professor Hazlett cited ILEC investment to be \$2,311 per line, compared to the \$2.92 a month that a California competitor would pay to rent access to the ILEC’s line — a return that did not even recover the interest on investment.<sup>30</sup>

As for other artificially low wholesale prices, one study found that unbundled network element prices gave ILECs only 42% of their normal retail revenues. While another study found that regulated prices would need to be increased by 60% to prevent losses. Economists noted that it would take 20 years of aggressive productivity improvements to recover from the one-time drop to the new regulated wholesale prices.<sup>31</sup> Because of the onerous cost of regulations and the risk associated with renting facilities to competitors at bargain prices, ILECs were discouraged from investing in their own broadband services. Competitors were discouraged from investing, too, because leasing unbundled elements was cheaper than building. Effectively, artificially low UNE and line sharing pricing created fake competition, and once prices were more aligned with costs, dozens of CLECs went bankrupt.

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<sup>29</sup> Telecommunications Act of 1996, Public Law 104-104, February 8, 1996, at [Statute-Pg56.pdf \(govinfo.gov\)](#)

<sup>30</sup> Steve Pociask, “Putting Broadband on High-speed: New Public Policies to Encourage Rapid Deployment,” Economic Policy Institute, Washington, DC, 2002; and Thomas W. Hazlett, “Regulation and Vertical Integration in Broadband Access Supply,” AEI-Brookings Joint Center for Regulatory Studies Conference, Broadband Communications: Overcoming the Barriers, Oct. 2001, p. 12.

<sup>31</sup> Much of this paragraph comes from Steve Pociask, “Putting Broadband on High-speed: New Public Policies to Encourage Rapid Deployment,” Economic Policy Institute, Washington, DC, 2002; Thomas W. Hazlett, “Regulation and Vertical Integration in Broadband Access Supply,” AEI-Brookings Joint Center for Regulatory Studies Conference, Broadband Communications: Overcoming the Barriers, Oct. 2001, p. 12; 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; Steve Pociask, “Competition at Bargain Prices,” *America’s Network*, December 15, 1998; 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.

“Open access” creates the wrong incentives for investment in innovation and expansion.<sup>32</sup> The benefits of investments must be shared with competing companies while the investor still bears all the investment costs. The incentive for competitive investment is reduced, while the incentive to piggy-back on someone else’s investments increases. Unbundling at bargain prices does not work.<sup>33</sup>

The experiment with open access failed. Unbundling continues today, but prices are aligned with costs and often based on mutually agreed rates and terms. Similarly, reciprocal switching could exist today, if it were based on mutually agreed upon rates and terms. Regulators should avoid repeating these past mistakes.

### Other Backdoor Attempts to Regulate Freight Rail Prices

Proposals for revenue adequacy regulations would allow the STB to determine rates for certain freight shipments based on what it determines to be an appropriate return on investment.<sup>34</sup> The concept is based in the 19<sup>th</sup> century observation that freight rail shipping companies were local monopolies. As this paper has shown, this is no longer the case for the 21<sup>st</sup> century freight shipping industry, which must compete with intermodal means of freight transport. Despite the intent of the regulations, some rail companies do not meet the revenue adequacy requirements.<sup>35</sup> In 2020, for example, two of the seven Class 1 rail carriers did not meet the 7.89% return as required.<sup>36</sup> Were the Board to utilize its revenue adequacy determination to cap individual rail shipments, those regulations would be similar to rate of return regulation and result in similar problems as described earlier in this paper.

Current law often rests on the term “reasonable,” which is dependent upon the facts of the specific case. For example, a shipping company named Sanimax is currently pursuing action through the STB against Union Pacific under the common carrier requirement to provide reasonable service.<sup>37</sup> In this case Sanimax claims that a reduction of service from five days a week to three days a week did not meet the standard of “reasonable” service. Union Pacific

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<sup>32</sup> George Bittlingmayer and Thomas Hazlett, ““Open access:” the ideal and the real,” *Telecommunications Policy*, volume 26, issue 5 – 6, 295 – 310, <https://www.sciencedirect.com/science/article/abs/pii/S0308596102000149>.

<sup>33</sup> Steve Pociask, “The Effects of Unbundling at Bargain Prices,” Competitive Enterprise Institute at <https://cei.org/studies/the-effects-of-bargain-wholesale-prices-on-local-telephone-competition/>, and published in *America’s Network Magazine*, 2003.

<sup>34</sup> “Revenue Adequacy: A Calculation to Inform Regulators of Railroads’ Financial Health,” Association of American Railroads, May 2022, <https://www.aar.org/wp-content/uploads/2020/10/AAR-Revenue-Adequacy-Fact-Sheet.pdf>.

<sup>35</sup> Lawrence Spiwak, “Ensuring Due Process at the Surface Transportation Board,” *Federalist Society Review*, June 2, 2020, <https://fedsoc.org/commentary/publications/ensuring-due-process-at-the-surface-transportation-board>.

<sup>36</sup> “Railroad Revenue Adequacy – 2020 Determination,” Surface Transportation Board, September 7, 2021, <https://www.stb.gov/news-communications/latest-news/pr-21-39/>.

<sup>37</sup> Bill Stephens, “Small shipper’s case against Union Pacific tests railroad common-carrier obligation,” *Trains*, June 15, 2022, <https://www.trains.com/trn/news-reviews/news-wire/small-shippers-case-against-union-pacific-tests-railroad-common-carrier-obligation/>.

claims that its railcars were not fully utilized when loading Sanimax’s cargo five days a week. The STB is investigating this case to determine if there is merit to the complaint under current common carrier obligation based on the requirement of “reasonableness,” which is a fact-specific determination.

The STB has tried several methods for determining a “fair” rate for shipping goods on freight rail networks, including the three-benchmark test, which uses three prices charged for similar services, and the simplified stand-alone cost (simplified-SAC) method that attempts to identify cross-subsidization with other parts of railroad for captive customers.<sup>38</sup> The three-benchmark test was rarely used by STB, reflecting the unique nature of most shipping agreements when considering origin, destination, and what is being shipped. Attempts by shippers to use the simplified-SAC are also rare. The STB views this tendency as the result of prohibitively high costs. However, this interpretation ignores the competitive nature of the freight industry today, which prevents anticompetitive behavior.

In January 2023, the STB released a final rule on a new method for determining rates for captive customers, called the final offer rate review - which became effective in March 2023.<sup>39</sup> In cases where the STB determines a rail line has market dominance, both the customer and rail company submit final offers for the rate for service to the STB. Once it has received these offers, the STB chooses one of the proposed rates with no hearing and no option to alter it in any way. While the STB argues that uncertainty of its choice limits each side’s ability to take extreme positions,<sup>40</sup> the ability to choose methodologies undermines that. Allowing each organization to choose its own methodology creates an incentive for the customer and rail company each to use their own method of determining the rate most favorable to them. Either side can create justifications for their own methodology that would complicate determinations of ‘fairness.’ Customers can choose a methodology that determines a rate below the actual cost of shipping their goods. Even if both the customer and rail company use arbitrary and unjustified methods of determining the rate, the STB would be stuck choosing one anyway, since they cannot reject both, nor would the Board have the discretion to modify the proposals before selecting one. These incentives are the exact opposite of those in a negotiated contract. Contracts require each side to find a way to benefit one another, while setting arbitrary prices through a bureaucratic and political process which encourages each side to view the transaction as zero-sum and attempt to extract as much out of the other party as possible. The binary, all-or-nothing nature of this decision process further highlights how the government is picking winners and losers within the rail freight sector.

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<sup>38</sup> Lawrence Spiwak, “Ensuring Due Process at the Surface Transportation Board,” *Federalist Society Review*, June 2, 2020, <https://fedsoc.org/commentary/publications/ensuring-due-process-at-the-surface-transportation-board>.

<sup>39</sup> “Final Offer Rate Review; Expanding Access to Rate Relief,” Surface Transportation Board, January 4, 2023, <https://www.federalregister.gov/documents/2023/01/04/2022-27926/final-offer-rate-review-expanding-access-to-rate-relief>.

<sup>40</sup> “Report to the Surface Transportation Board,” Rate Reform Task Force, April 25, 2019, <https://www.stb.gov/wp-content/uploads/Rate-Reform-Task-Force-Report-April-2019.pdf>.

There are serious questions about the constitutionality of final offer rate review, because of due process concerns.<sup>41</sup> The concerns stem from how the STB appears to not hold a full hearing of issues concerning the rate they choose, instead they pass their responsibility for choosing the methodology of ratemaking to the successful party. There is also potential for the binary choice structure to fall afoul of the takings clause of the Fifth Amendment if the shipping customer proposes a rate below the cost of shipping based on an arbitrary methodology and that rate is then chosen by the STB.

## Recent Legislative and Executive Proposals

Recent proposals in Congress and from the White House would move the freight rail industry back toward public utility-style regulation, threatening to undermine the growth in productivity and safety the freight rail industry has experienced over the past 40 years.

For example, in June of 2023, Senator Baldwin introduced a bill that would expand STB's authority to manage freight rail operations including both employment and equipment as well as requiring reasonable, timely, efficient, and reliable service without defining these terms in the context of freight shipping.<sup>42</sup> This bill is likely to lead to higher prices for goods shipped, encourage rent-seeking by large shippers looking for favorable rates, and return the industry to onerous regulations that were ended over forty years ago and which nearly bankrupted the industry.<sup>43</sup>

The reason for these regulations is not clear, considering there is no evidence that freight rail carriers have failed to meet their common carrier obligations.<sup>44</sup> It may well be that these regulations are being proposed to satisfy certain special interests, and not the public's interest. Regardless, the bill appears to be a very costly solution in search of a nonexistent problem.

The Freight Rail Shipping Fair Market Act, introduced in the House of Representatives in August 2022, attempts to define what "reasonable" service means in terms of common carrier requirements.<sup>45</sup> Under the guise of attempting to "clarify" the obligation, this bill would give the STB a mandate to more closely manage rail operations. "Reasonable" requests would have

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<sup>41</sup> Lawrence Spiwak, "Ensuring Due Process at the Surface Transportation Board," *Federalist Society Review*, June 2, 2020, <https://fedsoc.org/commentary/publications/ensuring-due-process-at-the-surface-transportation-board>.

<sup>42</sup> "S.2071 - A bill to amend section 11101 of title 49, United States Code, to ensure that rail carriers provide transportation or service in a manner that fulfills the shipper's reasonable service requirements," sponsored by Senator Tammy Baldwin, see <https://www.congress.gov/bill/118th-congress/senate-bill/2071>.

<sup>43</sup> "Issue Spotlight: Common Carrier Obligations for Rail Carriers," International Center for Law and Economics, March 16, 2023, [https://laweconcenter.org/spotlights/issue-spotlight-common-carrier-obligations-for-rail-carriers/?doing\\_wp\\_cron=1687455250.4940888881683349609375](https://laweconcenter.org/spotlights/issue-spotlight-common-carrier-obligations-for-rail-carriers/?doing_wp_cron=1687455250.4940888881683349609375).

<sup>44</sup> Ibid.

<sup>45</sup> Representative Donald Payne, "H.R.8649 – Freight Rail Shipping Fair Market Act," 117<sup>th</sup> Congress, August 2, 2022, <https://www.congress.gov/bill/117th-congress/house-bill/8649?s=1&r=7>.

to be timely, efficient, and reliable, but the legislation does not provide standards for any of these three terms and instead of viewing them in the context of all the facts and circumstances of a specific matter, including the network and other users thereof, views it from the perspective of the individual shipper. The legislation would empower the STB to determine service delivery standards, thus controlling the business decisions of the freight operator. The STB would also have to consider a host of new factors when determining if common carrier obligations are met, including frequency of service, rail employment, if requesters' needs are "reasonably" met, infrastructure and equipment, and how the customer's equipment is handled. The legislation would also bizarrely give the STB oversight of rail carrier equipment, including its availability, maintenance, and movement, as well as oversight of infrastructure and rail yards. All this amounts to bureaucratic control of corporate decisions in a manner reflective of the pre-Staggers Act regulations that caused rail shipping's previous decline.

In September 2022, the Reliable Rail Service Act was proposed,<sup>46</sup> which would also attempt to define "reasonable." It would enforce stricter rules for determining what is a "reasonable" request under the common carrier obligations. These rules include considerations for changes in frequency of transportation, employment changes, capital changes, whether the customer's needs are met, prior services rendered, and more. If the STB disagrees with the service of a rail company for shipping based on the provisions given above, it can instead second-guess the decisions of management to set the service level itself.

This is especially problematic because, while the "needs" of the customer are set as part of the standard in these proposals, little concern is shown for the needs of the railroad company or the needs of other customers who would also otherwise use the freight rail network. The proposed bill would give no consideration to how a given service may be less desirable to undertake, over another request for service that could be more profitable and less burdensome on the rail operator. Unlike a negotiated and mutually agreed-upon contract in which both parties agree to set terms, this bill would impose an arbitrary standard of "reasonableness" based on the shipper's wants.

Railroad companies do not have unlimited resources. When negotiated in the unrestrained market the needs of the customer, the rail operator, and other potential clients are all considered. The Railroad companies are better situated to judge their own capacity, capabilities, and needs of other their customers seeking service, and not the STB. Determining who a railroad company will serve and how it will do so by bureaucratic fiat removes the expertise of the railroad in its own business.

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<sup>46</sup> Senator Tammy Baldwin, "S.4959 – Reliable Rail Service Act," 117<sup>th</sup> Congress, September 27, 2022, <https://www.congress.gov/bill/117th-congress/senate-bill/4959/text?s=1&r=3&q=%7B%22search%22%3A%5B%22rail+baldwin%22%5D%7D>.

In July 2021, President Joe Biden issued an executive order that addressed rail regulations.<sup>47</sup> In this order, Biden instructed the STB to consider strengthening regulations on reciprocal switching, bottleneck rates, and interchange commitments. Bottleneck rate regulations limit what rail companies can charge single-served customers. Interchange commitments on the other hand are contracts that limit other railroads from using a specific rail line. In all three cases, the regulations unnecessarily limit both the decisions and profitability of freight rail companies under the old, misplaced assumption that they are local monopolies.

The original motivation for regulating rail pricing was to limit the probability and extent of monopoly power of railroads in the US. To view the modern freight shipping industry as being “monopolized” requires an arbitrarily narrow view of the industry. Other modes of transporting goods compete with freight rail, even on so-called bottleneck lines. Trucks are the largest form of freight transit in the U.S., calling into question whether a freight rail company can have a local monopoly in transporting goods. The era of freight rail being the only game in town for short and long-haul freight transport is long over.

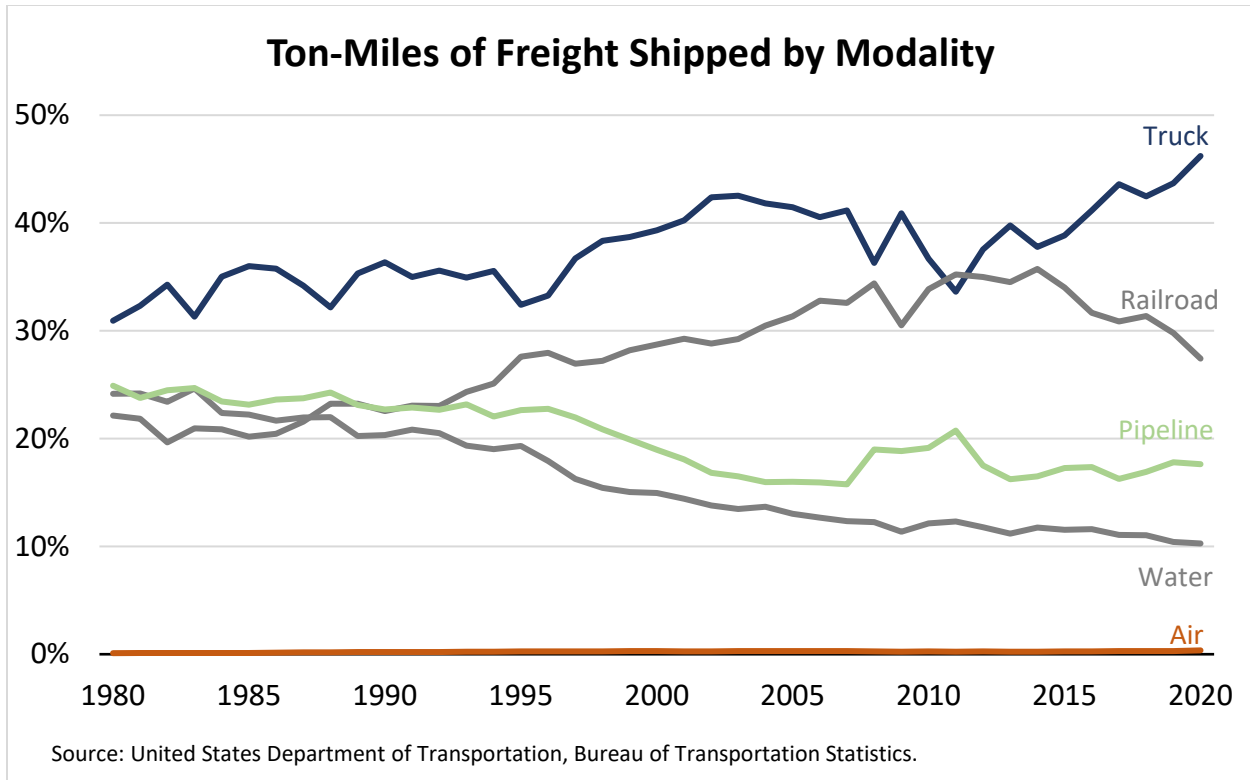
With competition provided by trucks, barges, pipelines, and airplanes, not to mention the product and geographic competition railroads face, there is no reason to move freight rail back to a system of public utility regulation. Except for the Jones Act<sup>48</sup> regarding water-based shipping, intermodal freight transport remains unconstrained by regulations as onerous as those the STB imposes on the railroad freight sector. Truck-based shipping has comprised a higher portion of U.S. freight shipping than rail in every year since 1980.<sup>49</sup> As of 2020, truck-based freight shipping accounted for 46% of all U.S. freight shipping, while rail composed only 27 percent. The remaining 23% of freight shipping is managed by pipeline, water transport, and air transport. Not only does truck-based shipping surpass freight rail shipping, but it has also increased at a faster rate than freight rail shipping. Singling out freight rail transportation puts it at a competitive disadvantage compared to other methods of transportation. Decreasing the profitability of rail freight transportation will disincentivize investment in the freight rail industry, moving the U.S. rail industry one step closer to a time when it did not have enough return on investment to maintain its infrastructure.

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<sup>47</sup> “Executive Order on Promoting Competition in the American Economy,” The White House, July 9, 2021, <https://www.whitehouse.gov/briefing-room/presidential-actions/2021/07/09/executive-order-on-promoting-competition-in-the-american-economy/>.

<sup>48</sup> “Jones Act,” Cornell Law School Legal Information Institute, accessed April 15, 2023, [https://www.law.cornell.edu/wex/jones\\_act](https://www.law.cornell.edu/wex/jones_act).

<sup>49</sup> “U.S. Ton-Miles of Freight,” U.S. Department of Transportation Bureau of Transportation Statistics, accessed April 11, 2023, <https://www.bts.gov/content/us-ton-miles-freight>.



Declines in the rail system necessitate shifting freight transportation from rail to other forms of transportation, primarily to trucks. Increasing truck-based transportation increases the cost the public must bear for the delivery of goods.<sup>50</sup> While trains travel on privately maintained tracks, trucks use publicly maintained roads to move goods. The additional wear from an increase in truck-based freight transportation leads to higher highway maintenance costs and therefore a greater burden on local and state infrastructure budgets which would otherwise have to account for less traffic on their roads.<sup>51</sup> The result is taxpayers picking up a larger portion of the cost of truck freight transit.

Trucks are also less efficient than freight rail in terms of carbon emissions per unit of cargo, increasing environmental damage.<sup>52</sup> As regulations push moving goods to inefficient second-choice transport options, someone will need to cover the increase in costs. This will result in some combination of higher consumer prices, higher shipping costs, or loss in freight

<sup>50</sup> David Austin, "Pricing Freight Transport to Account for External Costs," Congressional Budget Office, March 2015, page 3, [https://www.cbo.gov/sites/default/files/114th-congress-2015-2016/workingpaper/50049-Freight\\_Transport\\_Working\\_Paper-2.pdf](https://www.cbo.gov/sites/default/files/114th-congress-2015-2016/workingpaper/50049-Freight_Transport_Working_Paper-2.pdf).

<sup>51</sup> Richard Stewart, R. Christopher Williams, Jason Bausano, Elizabeth Ogard, and Anthony Pagano, "Rail to Truck Modal Shift: Impact of Increased Freight Traffic on Pavement Maintenance Costs," University of Wisconsin Transportation and Logistics Research Center, January 2008, <https://www.uwsuper.edu/tlresearchcenter/research-grants/upload/rail-to-truck.pdf>.

<sup>52</sup> "The Environmental Effects of Freight," Organization for Economic Co-operation and Development, 1997, <https://www.oecd.org/environment/envtrade/2386636.pdf>.



shipping profits, accelerating inflation, and increasing cost of living pressures on the average American consumer.

Decreases in freight rail transportation will have a damaging impact on reinvestment into the rail freight industry. For example, freight rail uses only 1.8% of the energy used in the transportation sector, with trucking as the dominant source of energy consumption.<sup>53</sup>

With an average industry investment of \$260,000 per mile of rail line, it has cost the industry \$700 billion over 40 years to build the infrastructure that exists today.<sup>54</sup> In 2018, industry investment to maintain and build its physical capital totaled \$24.9 billion. Some estimates put Class 1 railroad reinvestment at 20% of revenue.<sup>55</sup> However a look at Union Pacific's annual report for 2021 shows that of its \$9.6 billion in net cashflow from operating activities, 31% (\$2.9 billion) was reinvested as capital expenditures.<sup>56</sup> This does not account for other financial obligations, such as paying investors and taxes, leaving the reinvestment rate compared to net cashflow even higher.

As a percentage of revenue, freight rail companies spend six times as much as the average manufacturing company on capital expenditures.<sup>57</sup> Price controls that decrease industry revenue put downward pressure on reinvestment into efficiency and safety for an industry with a strong history of reinvestment into both.

Modern proposals to reregulate rail prices take the sector back to a period before the passage of the Staggers Act, when the industry faced financial losses and bankruptcies, low productivity, and inflated costs and prices. The regulatory reforms that took place in 1980 reversed all of that, adding billions of dollars of benefits in terms of consumer welfare. As Congress and regulators consider new regulations, it should be mindful of the past and not erase these gains.

## Conclusions and Next Steps

The STB and Congress should take into consideration the competitive structure of the modern freight shipping industry when considering regulatory changes. Listing the number of Class 1 freight rail operators or the number of rail lines that serve a particular route does not

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<sup>53</sup> "Transportation Statistics: Annual Report 2022," U.S. Department of Transportation, Figure 6-2. Also see The Bureau of Transportation Statistics for recent data at <https://www.bts.gov/>.

<sup>54</sup> "Rail," American Society of Civil Engineers 2021 Infrastructure Report Card, accessed April 9, 2023, <https://infrastructurereportcard.org/wp-content/uploads/2020/12/Rail-2021.pdf>.

<sup>55</sup> Ibid.

<sup>56</sup> "Class I Railroad Annual Report R-1 to the Surface Transportation Board for the Year Ending Dec. 31, 2021," Union Pacific, accessed April 15, 2023, [https://www.up.com/cs/groups/public/@uprr/@investor/documents/investordocuments/pdf\\_up\\_r1\\_2021.pdf](https://www.up.com/cs/groups/public/@uprr/@investor/documents/investordocuments/pdf_up_r1_2021.pdf).

<sup>57</sup> "Freight Rail's Investments Generate Huge Returns for America," Association of American Railroads, accessed April 13, 2023, <https://www.aar.org/article/freight-rails-private-investments/>.

reflect how competitive the market is for freight transportation. Capital-intensive industries tend toward fewer numbers of competitors due to economies of scale, and rail is a highly capital-intensive method of transportation.

Even with relatively few Class 1 freight rail companies, each still has to compete with the larger market of intermodal freight transportation options, not to mention pressure from product and geographic competition. Rail is no longer the major mode of freight transport, let alone an oligopoly. Regulations that target only one mode of transport will only serve to make that mode less competitive compared to alternative transportation choices. This only further distorts the allocation of resources invested between modalities away from regulated modalities to those that are less regulated. That will have negative consequences for industries, taxpayers, and the environment.

When the ICC first imposed rate of return and other price regulations on the rail system, intermodal competition was substantially less developed than what it is today. This means that even small or innocuous regulations can have substantial effects on the method in which customers transport their goods. Instead of expanding common carrier requirements to appear closer to the ICC's former regulations, policymakers consider streamlining the existing standard and limiting regulatory overreach.