234311
ENTERED
Office of Proceedings
May 29, 2013
Part of
Public Record

**Before the**
**SURFACE TRANSPORTATION BOARD**
**Washington, D.C. 20423**

| | | |
|---|---|---|
| **In the Matter of** | ) | **Docket No. EP 711** |
| | ) | |
| **Petition for Rulemaking to Adopt** | ) | |
| | ) | |
| **Revised Competitive Switching Rules** | ) | |

# REPLY COMMENTS OF THE COMPETITIVE ENTERPRISE INSTITUTE

**May 29, 2013**

**Prepared by:**

Marc Scribner
Fellow in Land-use and Transportation Studies
Center for Economic Freedom
Competitive Enterprise Institute
1899 L Street NW, 12th Floor
Washington, D.C. 20036
(202) 331-1010
mscribner@cei.org

On behalf of the Competitive Enterprise Institute (CEI), a non-profit public policy organization that specializes in regulatory policy, I respectfully submit this letter in reply to the *Petition for Rulemaking to Adopt Revised Competitive Switching Rules*.[1]

This comment letter develops the following points:

1. NITL and supporters of its flawed proposal ignore the underlying economics of network industries and seek to require the Board to make arbitrary and capricious rulings on rates and access.

2. Revised competitive switching rules for the limited short-run benefit of captive shippers will harm railroads, shippers, consumers, and the overall economy in the long-run.

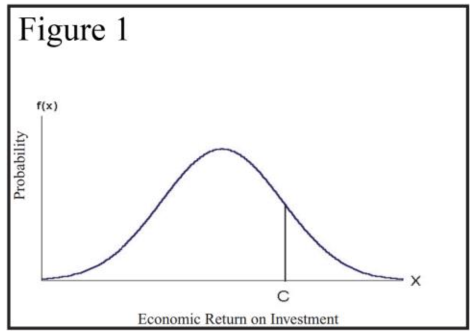
3. On these grounds, the Board should reject NITL's proposal and other calls for new forced access regulations.

## 1. NITL and supporters of its flawed proposal ignore the underlying economics of network industries and seek to require the Board to make arbitrary and capricious rulings on rates and access.

The current proceeding before the Surface Transportation Board ("Board") was prompted by the National Industrial Transportation League ("NITL"), a lobbying group supported by some shipping interests. NITL has a long history of regulatory advocacy on behalf of its members. While this advocacy is understandable, NITL and others who support its proposed competitive switching rule revisions fail to understand the underlying economics of network industries.

George Priest, John M. Olin Professor of Law and Economics at Yale Law School, has argued that while most "[a]ntitrust analysts and courts are presumptively suspicious of the possession or extension of market power," this suspicion "[i]n the context of a network industry" is "inappropriate" because it ignores "positive externalities generated by network participation."[2] Priest continues, "Thus, many of the traditional presumptions with respect to industrial practices and industrial structure are not available and are even counterproductive in the context of networks."[3] Professor Priest goes on to call for a complete reorganization of contemporary antitrust understanding with respect to network industries.[4]

[1] Decision of the Surface Transportation Board in the matter of *Petition for Rulemaking to Adopt Revised Competitive Switching Rules*, July 25, 2012, Docket No. EP 711, as modified on October 25, 2012.
[2] George L. Priest, "Rethinking Antitrust Law in an Age of Network Industries," John M. Olin Center for Studies in Law, Economics, and Public Policy, Yale Law School, Research Paper No. 352, November 2007, p. 7, http://ssrn.com/abstract=1031166.
[3] Ibid., p. 9.
[4] Ibid., pp. 39-42.




An error often made when analyzing the efficiency of markets is the assumption that public policy can easily address market failure or other perceived market imperfections. In reality, the net social costs of government failure in attempting to remedy suboptimal market outcomes frequently outweigh the costs of the alleged market failure itself. As New York University economist Lawrence Wright has astutely noted, "governments are not omniscient"[5] and they "may not be the benevolent neutral entities of textbooks."[6] On the contrary, regulatory bodies are frequently captured by commercial interests, which then drive socially harmful, anti-competitive policies. As a result, "the efforts of government to fix the potential problems of networks may well go awry."[7]

Shippers have challenged the discrimination among firms in freight rate-setting by arguing that these practices undermine social welfare. However, economic historian Marc Levinson argues that this sort of discrimination in the railroad industry is not only welfare-enhancing, but that "the end of the ban on discrimination was the most important result of the deregulation of freight transport."[8]

Under forced access, impacted shippers would face rates closer to variable costs, but these rates would reflect neither the large capital costs nor the inherently higher risk due to the presence of sizable sunk investments. This danger has been highlighted by Massachusetts Institute of Technology economist Jerry Hausman. The railroads' sunk investments cannot be simply sold or used elsewhere. They are functionally immobile. However, while the cost-based regulation proposed by NITL puts a ceiling on the possible (in a probability distribution) positive economic returns of regulation, there is no floor on possible deleterious economic effects. Hausman notes that this results in an asymmetric and truncated probability distribution of returns on sunk investments (Figure 1, where C represents the limit on potential positive economic returns).[9]

Weakening ownership rights by implementing forced access policies in the name of competition and enhanced access would ironically likely reduce rail access in the future, as railroads would face diminished incentive to invest in infrastructure that serve only a small number of shippers.

Re-regulatory policies to ostensibly promote competition in fact serve to reduce the return on investment and thus the incentive to modernize and expand network facilities to meet changing traffic patterns and commodity mixes. The $500 billion the railroad industry has reinvested into its networks since the Staggers Act is of its magnitude because deregulation allowed owner-

---

[5] Lawrence J. Wright, "U.S. Public Policy Toward Network Industries," *Reviving Regulatory Reform* conference, American Enterprise Institute, January 16-17, 1996, p. 20, http://ssrn.com/abstract=164500.
[6] Ibid., p. 21.
[7] Ibid., p. 22.
[8] Marc Levinson, "Two Cheers for Discrimination: Deregulation and Efficiency in the Reform of U.S. Freight Transportation, 1976-1998," *Enterprise & Society* Vol. 10 No. 1, March 2009, p. 178.
[9] Jerry Hausman, "Will New Regulation Derail the Railroads?" Washington, D.C.: Competitive Enterprise Institute, October 1, 2001, p. 7, http://cei.org/pdf/2899.pdf. *See also*, Jerry Hausman and Stewart Myers, "Regulating the United States Railroads: The Effects of Sunk Costs and Asymmetric Risk," *Journal of Regulatory Economics* Vol. 22 No. 3, 2002, pp. 287-310.

operators to behave as market agents, rather than as Interstate Commerce Commission bureaucrats' pawns.

The disgruntled shipper minority will never admit it, but the main reason why they lack whatever level of competition they would deem sufficient is that there is simply not enough demand for rail service for a competing railroad to justify investing in the area.

In its petition, NITL requested that the Board initiate a rulemaking to replace the current regulations governing access and replace them with a new dedicated part of the Code of Federal Regulations to lay out the conditions for mandatory reciprocal and terminal switching.[10] At its core, NITL's proposal seeks to force switching arrangements on rail carriers by removing the present requirement that abuse of market power must be found to mandate such practices. The proposal would impose forced access if the following four conditions are met:

1) The shipper or shippers are served only by a single Class I railroad;
2) There is no effective intermodal or intramodal competition for the freight movements in question;
3) "A working interchange" exists or could exist within a "reasonable distance" of the shipper's or shippers' facilities; and
4) Mandating switching is feasible and safe, and would not unduly hamper the affected carrier's ability to serve its shippers.[11]

The first condition tells us little about market conditions, while the third and fourth—in addition to the vagaries of "reasonable," "feasible," and "unduly"—depend on a determination of lack of effective competition under the second condition. Unsurprisingly, it is under this second condition where NITL seeks to make most of its mischief.

The second condition, as summarized by NITL in its proposal to the Board, states:

> The petitioner shows that there is no effective inter- or intramodal competition for the movements for which competitive switching is sought. There would be no consideration of product or geographic competition. There would be a conclusive presumption that there is no such effective competition where either: (a) a movement for which competitive switching is sought has an R/VC ratio of 240% or more; or (b) the Landlord Class I carrier has handled 75% or more of the freight volume transported for a movement for which competitive switching is sought in the twelve months prior to the petition seeking switching.[12]

NITL is arguing the Board should not to take into account potentially relevant information related to product or geographic competition, which can surely impact a carrier's investment, risk assessment, and service charges in a variety of ways throughout the network. NITL's ideal competitiveness standard, that any rates at or exceeding a revenue-to-variable-cost ratio of 240

[10] 49 CFR 1144.2. The new part would be at 49 CFR 1145.
[11] The National Industrial Transportation League before the Surface Transportation Board in the matter of *Petition for Rulemaking to Adopt Revised Competitive Switching Rules*, July 7, 2011, Docket No. EP 711, Filing ID 230578, Appendix A, p. 65.
[12] Ibid.

percent will automatically be found harmful, is an arbitrary standard that not only ignores the wide variation in risk to sunk investments across network segments, it would rely on the outdated Uniform Railroad Costing System to make determinations under it.[13]

The second standard, the 75-percent-or-more carrier market share, is even more absurd. It is likely that many of the segments in question were constructed by carriers and operated for the specific disgruntled shippers. The risk of these low-demand segments is quite large and it would only take the exit of one or a couple of shippers from the market to render the segment unprofitable. This would discourage future railroad investment aimed to increase capacity and access for shippers with similar characteristics and would ultimately harm rail carriers, shippers, and consumers by reducing network efficiency and access.

Instead of having the Board rely on actual evidence of abuse, NITL proposes that regulators should be permitted to make arbitrary and capricious determinations based on faulty data in order to allow its members to extract short-term rents from rail carriers. The current regulations, while far from perfect, are superior to the blatant rent-seeking contained in NITL's dangerous proposal.

## 2. Revised competitive switching rules for the limited short-run benefit of captive shippers will harm railroads, shippers, consumers, and the overall economy in the long-run.

There is no question that giving into the political demands of vocal captive shippers would in the short-run provide limited rate relief to said shippers. However, given the history of railroad regulation and deregulation in the United States, any acquiescence on the part of the Board will likely harm railroads, shippers, consumers, and the overall economy in the long-run.

Shippers represented by NITL and others have long engaged in anti-market behavior. Their criticisms of rail pricing have changed little in the decades following the enactment of the Staggers Act and will likely continue on a similar course indefinitely.

Brookings Institution economist Clifford Winston has noted that since deregulation, rail carriers have faced intense competition—both intramodal and intermodal. Winston recognizes that captive shippers exist, but that the problem is far smaller than the shipper lobby claims and the Board's rate complaint process is inherently too cumbersome and costly to be of any real use.[14] Winston argues:

> [G]overnment should not pursue policies such as mandatory access to increase competition. Instead, it would be preferable to eliminate the Surface Transportation Board and completely deregulate rail rates while instituting market-based mechanisms to

[13] *See, e.g.*, Douglas W. Caves, Laurits R. Christensen, and Joseph A. Swanson, "The Staggers Act, 30 Years Later," *Regulation*, Winter 2010-2011, p. 30: "Bluntly, the [Uniform Rail Costing System] is based on out-of-date statistical analyses, has other ad hoc assignments of costs, and is an inappropriate method for estimating the costs of specific movements."

[14] Curtis Grimm and Clifford Winston, "Competition in the Deregulated Railroad Industry: Sources, Effects, and Policy Issues," *Deregulation of Network Industries: What's Next?*, Eds. Sam Peltzman and Clifford Winston, Washington, D.C.: Brookings Institution, 2000.

> address the captive shipper issue. In the process, the potential for policymakers to adopt measures that effectively re-regulate the industry would be foreclosed.[15]

While this is obviously beyond the scope of the Board's powers (as it cannot abolish itself), it is a matter Congress should take seriously. The Board is approaching functional obsolescence and will definitively reach that milestone if it caves to NITL's rent-seeking demands.

Bolstering Winston's position is the widely acknowledged fact that the deregulatory process that began in earnest with the 4R and Staggers Acts is not yet complete. Until recently, America's Class I railroads were not even revenue-adequate.

Economists Siew Hoon Lim and C.A. Knox Lovell developed a three-stage short-run profit decomposition model to determine the causal factors behind profit and productivity changes over time. They note:

> Linking economic performance to financial performance is important, especially in a quasi-regulatory environment in which the regulator wants to encourage better economic performance in order to protect consumers of railroad services without bankrupting the railroads. *The regulator absolutely must take into account the financial implications (for the firms as well as for the consumers) of regulatory decisions, and the linking between economic and financial performance should not be overlooked*.[16] (Emphasis added.)

Not merely using index numbers (as most studies do) Lim and Lovell found that the divergence between productivity and profitability in the railroad industry during 1996-2003 can be attributed largely to increasing input prices and capacity constraints.

This finding is not out of the ordinary. More recent analysis largely confirms the Lim and Lovell conclusion. For instance, in Christensen Associates' final January 2010 report to the Board, they conclude that "increases in the railroads' generic costs […] were driven primarily by the spike in fuel prices in recent years. Thus, while shippers have been exposed to increasing RPTMs after 2004, it appears that costs rather than markup factors are largely the culprits."[17]

But this has not stopped NITL from advocating forced access policies based on the baseless assumption of market power abuse on the part of the railroads. Even more absurdly, NITL in its most recent filing to the Board argues that their proposed forced access requirements won't impact railroad efficiency because similar regulations in Canada have not had obvious deleterious effects.

---

[15] Winston, "The United States: Private and Deregulated," *Competition in the Railway Industry: An International Comparative Analysis*, Eds. José A. Gómez-Ibáñez and Ginés de Rus, Northampton, Mass.: Edward Elgar Publishing, 2006, pp. 149-150.

[16] Siew Hoon Lim and C.A. Knox Lovell, "Profit and Productivity of US Class I Railroads," *Managerial and Decision Economics* Vol. 30, January 2009, p. 436.

[17] Surface Transportation Board, "An Update to the Study of Competition in the U.S. Freight Railroad Industry," Final Report, prepared by Laurits R. Christensen Associates, January 2010, p. 6-17, http://www.stb.dot.gov/stb/docs/CompetitionStudy/Final/January%202010%20Report.pdf.

In contrast to NITL's claim that "[t]here is no reason to believe that the same dynamic would not take place in the United States under the [NITL competitive switching proposal],"[18] adopting Canadian-style forced access rules would increase railroad network complexity and reduce efficiency. To understand why it is inappropriate to equate Canadian experiences with potential future American experiences, consider the following: the U.S. has nearly 10 times the population density of Canada; the U.S. has four times as much track per square mile as Canada; there are on average 10 times as many interchanges per metropolitan area in the U.S. compared to Canada. To claim U.S. and Canada are materially similar with respect to railroad service and access betrays either a deep ignorance of both national rail markets or intellectual dishonesty.

This potential for high error costs and regulatory uncertainty is not merely academic. At a June 2011 hearing during the Ex Parte 705 proceeding, Thomas Wadewitz, managing director of Airfreight and Surface Transportation at J.P. Morgan Securities, highlighted the dangers of reregulation from the perspective of investors. Wadewitz noted that "uncertainty is a source of risk. So while the outcome [of regulatory change] may be favorable, if an extended process of considering change in regulation is pursued, that can act as a headwind to rail investors and also to investment decisions."[19]

In response to questioning from Commissioner Francis Mulvey, Wadewitz stated the obvious by noting that imposing regulations that restrict market pricing will reduce earnings, thereby reducing the investor attractiveness of railroad securities and shareholder willingness to tolerate significant reinvestment of profits, and in the end reducing much-needed investment in railroad infrastructure:

> But if ultimately you put in place those changes that do negatively affect pricing, which then affects earnings growth and returns, then there will be less interest from shareholders, and it will incentivize the managements to take a different course … So in industries where returns are not particularly good, then shareholders will put more pressure on the industry to invest less. So if your desired result is less investment, then that can be a course that you go to.[20]

Adopting NITL's competitive switching proposal would deter railroad investment when capacity constraints are becoming more serious. Ironically, level of service now and in the future is one of the biggest shipper concerns. Driven by the rise of intermodal movements and new sources of North American petroleum, rail traffic is expected to significantly increase in the coming decades. While the railroads are spending tens of billions of dollars of their own funds annually in order to meet this demand, and government programs such as CREATE seek to augment these private investments, much more is still needed. NITL's proposal is simply irresponsible from a practical perspective.

---

[18] The National Industrial Transportation League before the Surface Transportation Board in the matter of *Petition for Rulemaking to Adopt Revised Competitive Switching Rules*, March 1, 2013, Docket No. EP 711, Filing ID 233892, p. 60.

[19] Transcript of a public hearing before the Surface Transportation Board in the matter of Competition in the Railroad Industry, Docket No. 705, June 22, 2011, p. 482, http://stb.dot.gov/TransAndStatements.nsf/8740c718e33d774e85256dd500572ae5/e163ad72a36c38028525793c000ce7e8/$FILE/0622STB.pdf.

[20] Ibid., p. 497.

After recommending that policy makers should reject new forced access regulations, Winston responds to the oft-repeated but false assumption that railroad deregulation has been completed—thus potentially justifying more meddling from regulators in the name of competition:

> In fact, railroads still have a way to go to optimize service times and reliability, to be fully responsive to shippers, and to achieve potential logistical and operational efficiencies. A fully deregulated environment will spur the additional adjustments that the industry must make to accomplish these goals.[21]

Again, while the Board is (unfortunately) unable to abolish itself, it must be cognizant of the fact that if it oversteps its boundaries by adopting NITL's rent-seeking proposal, it likely will face enhanced and much deserved congressional scrutiny. If the Board uncharacteristically ceases to be "conservative in [its] exercise of authority,"[22] as Caves et al. describe the ICC and Board's general regulatory worldviews following the Staggers Act, it would indicate the Board has outlived its purpose and should be abolished by Congress, as has been suggested in the past by Winston and others.

### 3. On these grounds, the Board should reject NITL's proposal and other calls for new forced access regulations.

As we have stated in our multiple filings to the Board in the Ex Parte Nos. 705 and 711 proceedings, the Board should be wary of calls to re-regulate the railroad industry.[23] As NITL ignores the underlying economics of network industries, seeks to require the Board to make arbitrary and capricious rulings on rates and access, and fails to acknowledge the harm their proposal will do carriers, shippers, consumers, and the overall economy, the Board should reject NITL's competitive switching proposal.

---

[21] Winston, p. 150.

[22] Caves et al., p. 30.

[23] *See*, Comments of the Competitive Enterprise Institute before the Surface Transportation Board in the matter of *Competition in the Railroad Industry*, April 12, 2011, Docket No. EP 705, Filing ID 229233; Comments of the Competitive Enterprise Institute in Reply to Initial Comments of Consumers United for Rail Equity (CURE) before the Surface Transportation Board in the matter of *Competition in the Railroad Industry*, May 27, 2011, Docket No. EP 705, Filing ID 229648; *and* Comments of the Competitive Enterprise Institute in Reply to the National Industrial Transportation League's Petition for Rulemaking before the Surface Transportation Board in the matter of *Petition for Rulemaking to Adopt Revised Competitive Switching Rules*, August 2, 2011, Docket No. EP 711, Filing ID 230747.