



Modernizing Freight Rail Regulation

**RAIL TRANSPORTATION OF GRAIN, RATE REGULATION REVIEW
Docket No. EP 665 (Sub-No. 1)**

**Richard Schmalensee
June 10, 2015**

Congressional Study Request

Examine and Make Recommendations on:

- **Rate and service trends, post-Staggers**
- **Regulatory performance in balancing revenue adequacy and reasonable rates**
- **Future role of STB in regulating rates and service**

Funded by USDOT

NAS/TRB Role:

- **Congressionally chartered to advise government**
- **Committee members: no financial conflicts, balance of views and expertise, serve pro bono**
- **Reports are peer reviewed, fully independent**

Committee for a Study of Freight Rail Regulation

- **Richard Schmalensee, MIT, *Chair***
- **Ken Boyer, Michigan State University**
- **Jerry Ellig, George Mason University**
- **Tony Gómez-Ibáñez, Harvard University**
- **Anne Goodchild, University of Washington**
- **Wes Wilson, University of Oregon, Eugene**
- **Frank Wolak, Stanford University**

Study Process

Briefings by:

Government agencies (STB, FRA, USDA)

Railroad industry (AAR, Short-lines)

Rail Labor

Shipper Groups (coal, grain, chemicals, other)

Briefings on Canadian system

Academic Experts and Consultants

Review of literature & STB documents

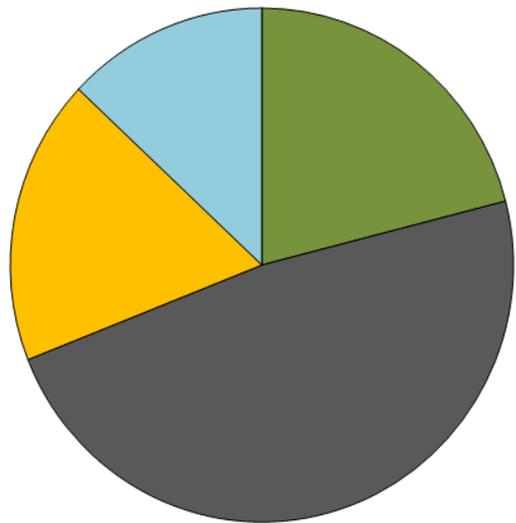
***Statistical Analysis* of Carload Waybill Sample**

Closed Deliberations to Develop Report

Use of Common Carriage (with Reasonable Rate Obligation)

Share of Total Common Carriage Ton-miles

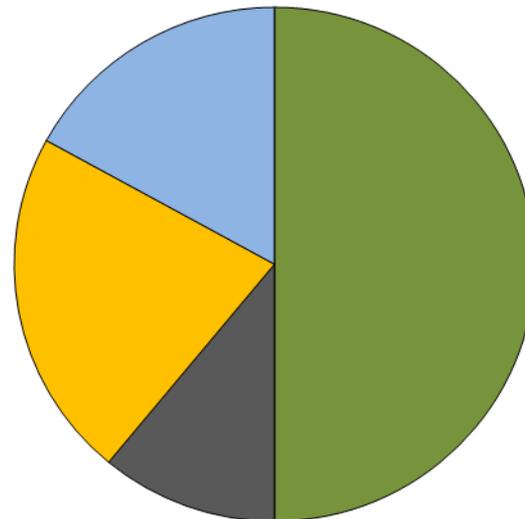
Year 2000



- Grain/Food
- Coal
- Chemicals
- Other

- >Coal drops from 48% to 11%
[Use falls from 52% to 5%]
- >Grain/Food up from 21% to 50%
[Use **remains** ~70%]

Year 2012



Current Rate Relief Process: 3 Steps

- 1. Initial screen: 180% R/VC formula, using URCS VC numbers**
- 2. Market dominance inquiry for rates > 180% R/VC**
- 3. Rate reasonableness ruling: SAC, simplified SAC, or 3-benchmark**

Process, level of relief must respect the law's interest in protecting revenue adequacy

Best viewed as a “system”—a permissive and/or unreliable URCS R/VC screen will prompt regulators to rely on steps 2 and 3 to safeguard revenue adequacy.

Finding : Variable Cost Allocations (a la URCS) are Economically Invalid and Unreliable, Better Alternatives Exist

With joint & common costs, there is no economically valid measure of shipment-specific variable cost (in contrast to incremental cost)

- Omitted costs—costs not recorded in expense records (e.g., risk)
- Arbitrary time frame for fixed/variable determinations
- Any allocation of common cost is purely arbitrary
- So, no reason why rates should reflect URCS numbers

URCS is unreliable—but its unreliability is not random

- Some types of traffic have uniformly high R/VCs
- Illogical results, 20-30% of traffic R/VCs below 100%

URCS cannot be fixed: Such cost allocation is fundamentally flawed

A better alternative: *use rates determined under competition for screening.* Not possible when Staggers was enacted, feasible now

Finding: Market Dominance Inquiries Should be Disciplined by Time Limits, not Categorical Limits on Evidence

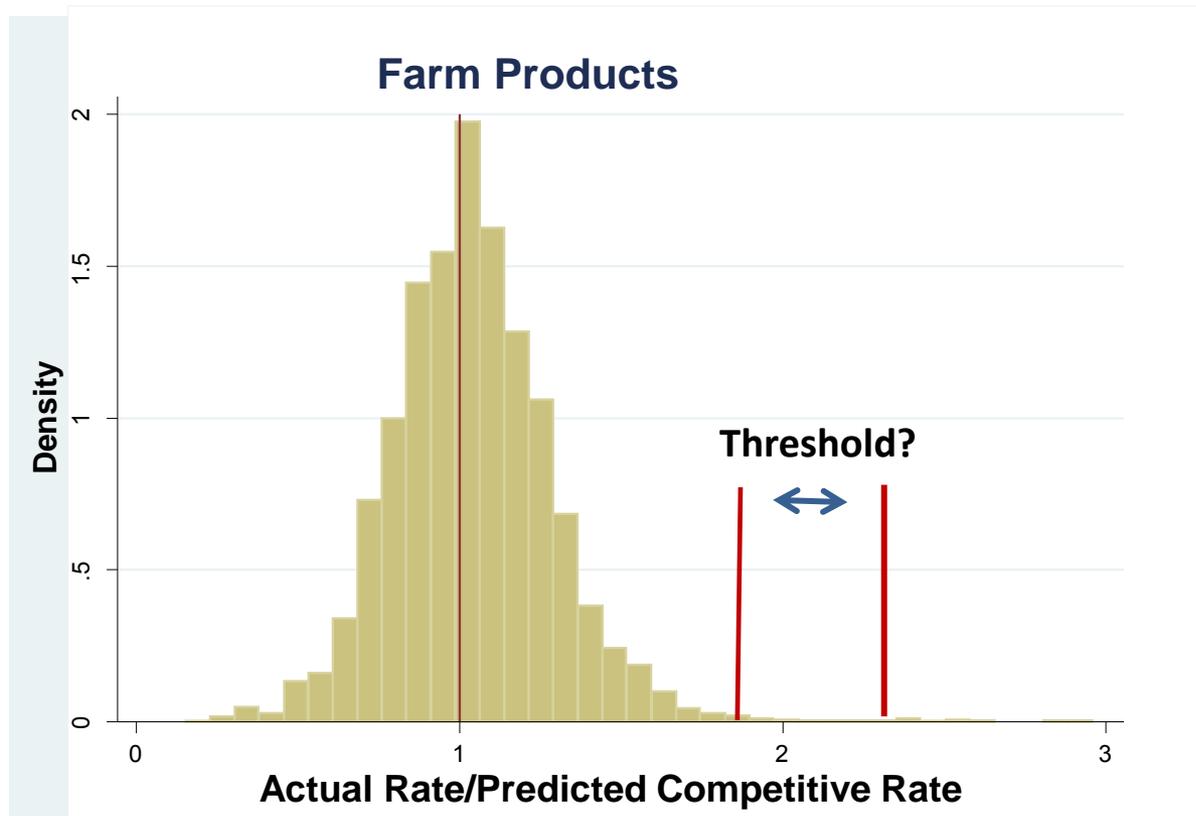
- **Considering all substitution possibilities can slow and deter cases, *but excluding evidence biases outcomes***
- **Antitrust agencies routinely examine complex product and geographic competition – *in informal proceedings***
- **Time limits on all sides compel prioritization of arguments**

Finding: Methods for assessing rate reasonableness lack a sound economic rationale and are unusable by most shippers; sounder and more economical methods needed

- **Railroads & shippers have incentives to move all profitable traffic, so rate relief is about fairness, not efficiency**
- **SAC aimed to prevent uneconomic entry in telecom (not an issue here!), not indicative of actual revenue needs, & too costly & time-consuming to be usable by small shippers**
- **Simplified procedures conceptually flawed, seldom used by shippers, & make more use of URCS – *the wrong direction!***

Recommendation: Prepare (via method development) to Replace R/VC and URCS With Competitive Rate Benchmarking

- Determines *potentially* unreasonable tariff rates based on comparable rates in competitive markets
- The farther a tariff rate is from its predicted level under competition, the more likely lack of competition was a factor



Competitive Rate Benchmarking (cont.)

- **Benchmarking (like the URCS R/VC test) can only identify plausible candidates for further scrutiny**
- **Regulators would determine the threshold(s), taking revenue adequacy into account.**
- **Threshold determination is likely to be controversial, *but transparent***
- **Report has a “proof of concept”; USDOT should develop, test, and refine competitive rate prediction methods.**
- **Legislation would be required to implement this approach**

Recommendation: Replace STB rate reasonableness hearings (dominance, SAC, etc.) with time-limited final offer arbitration

- **With a sound & unbiased screening tool, burdensome processes no longer needed for safeguarding revenue adequacy**
- **Arbitration is relatively informal, so can be fast, economical, & will not deter cases.**
- **Final offer rule will prompt compromise and settlement.**
- **Canada has shown effectiveness when accompanied by time limits**
- **Arbitrator should assess market dominance; competitive rate benchmark cannot assure dominance was cause of high rate.**
 - **No artificial evidence restrictions, only time limits**
 - **If dominance not demonstrated, case dropped or RR offer selected.**

Other Relevant Recommendations

Allow reciprocal switching to be proposed in arbitration proceedings

End annual revenue adequacy determinations; require periodic, deeper assessments of industrywide economic and competitive conditions.