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STUDY OF COMPETITION IN THE FREIGHT RAIL INDUSTRY

COMMENTS OF THE CONSUMER FEDERATION OF AMERICA ON NOVERBER 2008 REPORT OF L.R. CHREISTESEN ASSOCIATES, INC.

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WHY CONSUMER CARE ABOUT RAILROAD MONOPOLY POWER

The Consumer Federation of America

The Consumer Federation of America (CFA) appreciates the opportunity to comment on the recently release report entitled *A Study of Competition in the U.S. Freight Railroad Industry and Analysis of Proposals that Might Enhance Competition.* The CFA is a non-profit association of some 300-consumer groups with a combined membership of more than 50 million people. CFA was founded in 1968 to advance the consumer's interest through advocacy, research, and education.

CFA has been involved in the analysis of railroad competition and market power for a quarter of a century for a simple reason. Where there is a lack of competition consumers bear the burden of the abuse of rail market power. Where shippers are captive to a railroad, the railroad can set prices far above costs, extracting monopoly rents from shippers and ultimately consumers, or delivering poor service, which imposes costs on shippers, consumers and the nation.

Consumer Concerns about Rail Market Power

The problem facing consumers is particularly acute in the electricity sector. About half of all electricity generated in the U.S. is produced from coal and electricity is sold to consumers by franchise monopolies or with little competition. Almost three-quarters of coal used in the U.S. are transported by rail and it is a commodity over which the rails have a great deal of market power. Two-third of coal deliveries are to facilities that are served by only one railroad. Thus, excessive rail rates appear directly in consumer utility bills. For individual utilities, dependent on monopoly rail service, the excess charges can cost consumers as much as $300 per year per household.

Reflecting consumer impacts such as this, consumer advocates have a long history of involvement in efforts to secure better oversight over abusive practices in the rail sector. As the Staggers Act was being considered by the Congress, consumer groups expressed their concern that they would directly bear a significant part of the burden caused by the abuse of market power as consumers, when the prices are increased to reflect excessive rails rates. Even where costs increases are not passed through directly to consumers, the public should be concerned because excessive rail rates distort economic activity, reducing the efficiency of the economy, shifting jobs, and increasing the number of heavy trucks on the roads, which causes congestion and wear and tear on infrastructure.

The level of consumer involvement has reflected the level of abuse in the industry. Abuse began immediately after the passage of the Staggers Act and in recent years it has ramped up to unprecedented levels. Recent developments in the industry, including a shortage of capacity and rising energy prices, have opened the door to a dramatic uptick in the abuse of market power. In reaction, consumers and shippers have increased their efforts to convince policy makers to restore the consumer protections that the Congress intended be provided by the Stagger Act.

The underlying cause of the current problems is the poor design and lax implementation of railroad deregulation under the Stagger Rail Act of 1980. There is no doubt that the railroads were in bad shape in the 1960s and 1970s and in desperate need of economic rationalization. In the decade after the Staggers Act was signed into law, railroads made great strides in reducing costs, abandoning or shifting track to small rails, and restoring their financial health. Unfortunately, as frequently happened in the deregulation process of the 1980s and 1990s, the legislation went too far and the regulators did not provide effective oversight. Excesses soon set in that regulators failed to prevent.

Although the Staggers Act relied on competition to reform the industry, policy makers recognized that there might be a large group of captive shippers, shippers who lacked competitive alternatives – either rail-on-rail (intramodal) or truck/barge-on-rail (intermodal) competition. Since these shippers would not be protected from abuse by competitive market forces, the Staggers Act included captive shipper protections. The protections were weak and the regulators who implemented them, first the Interstate Commerce Commission (ICC) and its later replacement the Surface Transportation Board (STB), failed to effectively protect captive shipper from abuse.

These agencies not only failed to restrain unjustified rate increases on captive traffic, but they made matters worse by approving a string of mergers that dramatically reduced competition in the industry. To add insult to injury, the regulators failed to prevent anticompetitive pricing, routing, and contracting practices that further shut the door on competition. Two decades after the passage of the Staggers Act, four railroads (two in the east and two in the west) accounted for over 90 percent of rail traffic. Much of that traffic was vulnerable to the abuse of market power because the industry was allowed to become too concentrated. Captive shippers, who never had many competitive alternatives or lost those alternatives as a result of mergers, found themselves worse off under the Staggers Act.

The Burden of Abuse

Where head-to-head rail competition is lacking, shippers pay the price of captivity. Where the ultimate burden of excessive rail rates falls depends on the nature of the market into which the captive shippers sell their products, but in all cases the abuse of market power has a negative impact.

Where markets for end products are competitive, shippers will bear the burden. Placed at a competitive disadvantage vis-à-vis shippers who have competitive alternatives, the captive shipper will lose sales, or be forced to sift production to facilities that are not captive, either in the U.S. or abroad. Industrial shippers, particularly chemicals, fall into this category. The shippers and the economy bear the cost of the distortion introduced by the abuse of market power.

Where markets for end products are not competitive, the excessive rail rates will be passed through to consumers. Here the only constraint will be the market elasticity of demand for the end-product. Coal, which is predominantly used to generate electricity, is the primary example concern here. Although efforts have been made to introduce competition into electricity markets, the majority of markets are monopoly franchise markets and even where competition has been introduced, it is feeble at best. Thus, electricity consumers are the captives of utilities, who are the captive of the railroads. Electricity also has a low market elasticity of demand. Thus, the costs imposed by excessive rail rates are passed through directly to consumers.

These are the two extreme conditions and both result in economic distortions. In the competition case, it is the supply side of the shipper market where efficiencies and jobs are lost. In the monopoly case, end use consumers bear the burden. Some commodities, like agricultural commodities, exhibit a mix of these characteristics. Transportation costs affect the price of food paid by consumers in domestic markets. Farmers bear the burden of excessive rail rates for agricultural commodities that are exported for sale in world markets.

The Failure to Protect Consumers from Abuse

Because electricity is a consumer necessity that significantly affects household budgets and coal, which is a primary victim of the abuse of rail market power, is the dominant source of power to generate electricity, consumer groups pressed policy makers to address the problem of the unconstrained exercise of market power by the railroads throughout the 1980s. In a series of congressional testimonies[1] and reports[2] the Consumer Federation of America called on congress to require rail regulators to protect consumers from the abuse of market power.

In the past half-decade the costs imposed on captive shippers have increased as a result of mergers and consolidation in the rail industry, which increased the market power of the railroads. At the same time, the rise in commodity prices has spurred the rails to try to capture more rent from shippers. Thus, the ability and opportunity to raise shipper costs increased dramatically. As a result, rail profitability has improved dramatically with many railroads achieving or approaching revenue adequacy. Revenue adequacy should trigger greater constraint on rail pricing.

The Staggers Rails Act allowed the railroads to engage in differential pricing – to charge some shippers higher rates than others – in order to achieve revenue adequacy. In economic terms, this represents the exercise of market power, which is generally frowned upon in a competitive, capitalist economy. It is necessary in the case of the railroads because the railroads

[1] "The Staggers Rail Act of 1980," before the Subcommittee on Commerce, Transportation and Tourism of the Committee on Energy and Commerce, United States House of Representatives, July 27, 1983; "Oversight Hearings on the Staggers Rail Act of 1980," before the Subcommittee on Surface Transportation of the Committee on Commerce, Science and Transportation, United States Senate, July 26-27, 1983; "The Consumer Impact of the Proposed Norfolk Southern/Conrail Merger," before the Subcommittee on Commerce, Transportation and Tourism of the Energy and Commerce Committee, U.S. House of Representatives, July 10, 1985; "The Consumer Impact of the Unregulated Railroad Monopoly in Coal Transportation," before the Subcommittee on Monopolies and Commercial Law of the Judiciary Committee, U.S. House of Representatives, June 27, 1985; "Railroad Antimonopoly Act of 1986," before the Subcommittee on Commerce, Transportation and Tourism of the Energy and Commerce Committee, U.S. House of Representatives, June 5, 1986

[2] *Industrial Organization and Market Performance in the Transportation and Communications Industries*, July 1985; *The Great Train Robbery: Electric Utility Consumers and the Unregulated Rail Monopoly Over Coal Transportation, Overview, The Rail Monopoly Over Bulk Commodities, A Continuing Dilemma for Public Policy*, August 1985; *Bulk Commodities and the Railroads After the Staggers Act: Freight Rates, Operating Costs and Market Power*, October 1987.

have high fixed costs and exhibit economies of density. Congress knew that captive shippers would bear the burden of differential pricing because competitive market forces are inadequate to protect them, so the Staggers Act set limits on the exercise of market power. The ICC/STB was supposed to ensure that railroads did not earn excess profits and that all traffic made the maximum contribution it could to revenue adequacy. This would ensure that the railroads were run as efficiently as possible and that captive shippers would be treated as fairly as possible. The law allowed the use of market power, but sought to prevent the abuse of market power. The STB has failed to exercise it authority to properly protect consumes. After a quarter of century, neither efficiency nor equity has been achieved.

THE STB'S DISTORTED VIEW OF THE RAIL INDUSTRY

The competition report should have provided the STB with solid evidence to address the fundamental issues confronting the Board. Unfortunately, the report did not tackle the key issues head-on and did not provide a balanced view of its own data.

Captivity

The report fails to analyze the nature and extent of captivity that exists in the rail industry.

- For example, in a thousand page document, the most important facts with respect to competition – that two thirds (66 percent) of coal carried by the rails over half of all corn (53 percent) and one-third (33 percent) of chemical shipments is delivered to facilities that are served by only on railroad, -- is buried in a footnote about half way through the text (p. 18-14). There is a high probability that these shipments are captive, but the study provides no analysis of them and fails to define the geographic level properly for competitive analysis.
- The rates charged on captive traffic in comparison to non-captive shipments are not discussed.

- The status of captive traffic is never analyzed in detail. With hundred of tables and graphs, the following table which captures the essence of captivity is nowhere to be found in the document. The data does not even appear in text, being relegated to a couple of footnotes.

Percent of Revenues for Shipments Originating from or Destined to Counties Where only One Railroad Shipped the Specific Commodity

Commodity	Destination	Origination
Coal	66	35
Corn	53	64
Chemicals	33	34
Transport Equip.	28	34
Intermodal	21	11
Wheat	18	58
Soybeans	14	69

Source: A Study of Competition in the U.S. Freight Railroad Industry and Analysis of Proposals that Might Enhance Competition, pp. 18-15 n. 13, 18-14 n. 15.

Rates

The rate comparisons in the report are between hypothetical competitive situations not actual rates. It is based on the county as a unit of analysis, which overstates the level of competition. Although the hypothetical approach is less revealing than actual rates paid by specific shippers, the analysis shows that captive shippers pay much higher rates than shipper who enjoy competitive alternatives (pp. 12-8, 12-9).

- Coal delivered to facilities in counties that are served by only one railroad pay about 32 percent more than shippers in counties where two railroads deliver equal amounts of coal to a facility and 59 percent more than shippers in counties where there are three shippers delivering equal quantities of coal to a facility.

- Captivity on the originating end had less of an impact – with shippers in counties served by one railroad paying 6 percent more than origins served by two railroads of equal market shares and 10 percent more than origins with three railroads having equal market shares.

- An end-to-end captive chipper could be paying extremely high rates.

Excess Profits and Revenue Adequacy

The study locates the vast majority of its analysis at the wrong level. The key policy questions before the STB and the Congress involve specific commodities in specific markets served by specific railroads. The competition study devotes most of its attention to the industry as a whole, rather than specific railroads. This is a classic case where the average for the industry thoroughly misleads the policy maker. "For example, the study concludes that "Rates on average need to be marked up over marginal cost by about 70 percent to achieve revenues sufficient to cover cost" (p. 18-35).

- Two of the major national railroads (the Burlington Northern (BN) and the Norfolk Southern (NS) are well above that figure.

- The same two railroads have had a return on equity that far exceeded their cost of capital as calculated by the STB in 2005. For the BN, the return on equity was almost twice the cost of capital, while for the NS it was almost 1.5 times the cost of capital.

The study also shows that a large amount of traffic – one fifth –carried by the rails does not cover its variable cost. This means that if this traffic were shed, the profit of the railroads would increase. This represents a substantial inefficiency that suppresses the income of the railroads and increases the burden on captive shippers, in violation of the explicit language of the Staggers Act.

- The railroads that are not revenue adequate might be so, if they shed this non-compensatory traffic or raised the rates it pays. Those that are exceeding their cost of capital would do so by an even larger margin if they shed this non-compensatory traffic or raised the rates that it pays.

- Captive shippers are forced to suffer higher rates because of the persistent inefficiency embodied in this traffic.

The discussion of revenue adequacy is inadequate in other ways. After much deliberation, the STB has adopted a definition of the cost of capital for its revenue adequacy determinations, but the report dismisses this concept and fails to properly reflect it in its discussion. It seems to bend over backward to avoid giving proper weight to the fact that revenues are adequate for several railroads and have been so for a while (p. 8-35).

- This standard shows that in 2001- 2005 period the railroads are close to or exceeding revenue adequacy standard. The study brushes this finding off, stating that the standard is controversial, even though the proper methodology has finally been adopted by the STB.

- The study also cites a single 2004 Wall Street analysis that notes that the rails had just reached an adequate return, but makes no effort to look at more recent years. Yet if several railroads were at, or above revenue adequacy in 2005, they were likely well above it in the last couple of years because prices and profits have been rising sharply.

- There are numerous other Wall Street analyses that show that in recent years rail returns have exceeded their cost of capital and that rates continue to rise rapidly.

- These Wall Street analyses project that rates are likely to continue to rise as a result of the pricing power the railroads have achieved through mergers and the elimination of spare capacity.

The Reality of the Rail Industry

A fair and balanced view of the structure, conduct and performance of the rail industry since the passage of the Staggers Act reaches very different conclusions than the STB *Competition Analysis*.

Excessive consolidation resulting from mergers and lax oversight of anticompetitive business practices have given the railroads an immense amount of market power.

- The dramatic decline in the number of Class I railroads from almost 40 to 7, with two geographic duopolies dividing the country – one in the East and one in the

West – has carried consolidation far beyond anything that could have been justified on efficiency grounds. The level of concentration in railroad market is extremely high by any standard.

- The market power of the railroads was reinforced by the failure of the ICC/STB to prevent railroad conduct that undermined competition. The anticompetitive practices have been well documented for years including practice such as paper barriers, cancellation of interconnection agreements, and refusal to allow access to bottleneck facilities.

- As a result, a significant part of bulk commodities have been rendered captive to the rails. Coal is by far the most captive commodity with as much as two-thirds captive to a single railroad. Other commodities that have high levels of captivity are chemicals and agricultural commodities.

Failing to implement the captive shipper protections of the Staggers Act, the ICC/STB has allowed the railroads to abuse this market power.

- Profits of railroads that carry more than half the traffic in the U.S. exceed their cost of capital. This means that shippers are being overcharged by $2.5 billion per year.

- The excess profits have existed for several years on specific railroads and are the result of pricing power exercised by the rails.

- Wall Street analysts project that the pricing power will persist and drive up price and earning up over the next several years.

Significant quantities of traffic are carried by the rails at non-compensatory rates, violating the Staggers Act and increasing the burden on captive shippers.

- Approximately one-fifth of all traffic does not cover it variable costs, resulting in a cross-subsidy of over $2 billion per year.

- This increases the burden on captive shippers because it distorts the revenue adequacy status of the railroads.

As a result of the excessive profits and non-compensatory traffic, rates for captive shippers are higher than they should be. The productive and allocative inefficiency in the rail sector imposes inefficiencies on the broader economy because rail service is an infrastructural service on which other economic sectors are dependent. Inefficiency in the rail sector distorts shipper decisions about which fuels to burn and which plants to operate, which raises costs and reduces employment. It drives some freight traffic onto the highways adding to congestion and wear and tear on the roads.

CONCLUSION

A fair and balanced review of the state of the rail freight industry leads to the conclusion that the mergers of the mid-1990s have created a highly concentrated market structure in which neither intramodal competitive forces within the rail sector nor intermodal competition from trucks and water transport is sufficient to discipline the abuse of market power. Anticompetitive conduct has further weakened competition by undermining interline traffic. The STB has done little, if anything, to prevent or diminish this abuse. With captive shipper rates and rail profits escalating rapidly the harm to consumers, shippers and the economy is mounting rapidly. The need to address this growing national problem is urgent. The STB competition report fails to address the fundamental issues directly.

Justice delayed is justice denied. A quarter of a century after the passage of the Staggers Act captive shippers have a right to demand that regulators no longer allow this inefficiency to burden captive shippers. The STB has failed to address this problem, in violation of the Staggers Act, and it competition analysis ignores this problem entirely,

The STB has failed to implement the captive shipper and precompetitive provisions of the Stagger Act to protect the public. We identified this central problem a quarter of a century ago. It has festered ever since and, as we have shown in the above analysis, now costs consumers billions of dollars per year.