STB EX PARTE NO. 575

REVIEW OF RAIL ACCESS AND COMPETITION ISSUES

Decided April 16, 1998

After holding oral hearings, the Board initiates broad review of several railroad access and competition issues.

BY THE BOARD:

At the request of Senator John McCain, Chairman of the Senate Committee on Commerce, Science, and Transportation, and Senator Kay Bailey Hutchison, Chairman of the Subcommittee on Surface Transportation and Merchant Marine, the Board conducted 2 days of informational hearings, on April 2 and 3, 1998, to examine issues of rail access and competition in today's railroad industry. After reviewing both the written statements and oral testimony presented by over 60 witnesses, we have decided to pursue certain issues in the manner described in this decision.

Overview

There is no dispute that the Staggers Rail Act of 1980 (Staggers Act), as implemented and administered first by the Interstate Commerce Commission (ICC) and now by the Board, has revitalized American railroads. Whether the railroads have improved their financial condition enough or too much, and at the expense of rail-dependent shippers, are issues of ongoing debate that were not resolved by the hearings. What the hearings did clearly show, however, is that there is widespread discontent today among those who use rail service. At the hearings, shippers complained of inadequate service and higher rates, regulatory remedies that they regard as more theoretical than real, and regulatory processes that they view as burdensome, costly, and unresponsive.

While the Staggers Act was successful in spurring the railroads' economic recovery, at the core of shippers' complaints is their concern that the railroad industry is now dominated by a handful of large, Class I railroads, and as a result, shippers that are dependent on rail service increasingly lack competitive options. Shippers assert that, while the Staggers Act was meant to revive a failing industry and enable it to earn adequate revenues, Congress did not intend to thwart the equally important statutory goal that, to the maximum extent possible, competition should drive the railroads' economic recovery. The shippers' view is that, whether intentionally or not, implementation of the Staggers Act has met the former goal, but not the latter. The various recommendations for change made by the shippers at the Board hearings are intended to address this concern, and certain of the regulatory changes being proposed are embodied in S. 1429, legislation introduced by Senator Rockefeller and co-sponsored by Senators Burns and Dorgan.

Carriers take the position that the problems shippers face today are not structural but operational, highlighted by ongoing service failures in the West, and the railroad industry has pledged to re-examine with shippers the adequacy of current remedies designed to address service failures. The railroads argue that some of the proposed shipper solutions to the concerns expressed about competition would simply transfer wealth from carriers to shippers, and that, while access may produce lower rates for the short term, the various "open access" remedies shippers seek would, if adopted, ultimately undo the gains achieved by the Staggers Act. The railroads argue that reducing their earnings would deprive carriers of funds needed to replace existing rail facilities and to invest in new infrastructure required to resolve service problems such as those recently experienced in the West and to meet added service demands in a growing economy.[1] The railroads further maintain that existing remedies can address any pricing and competitive abuses, and that shippers have not explained how new remedies intended to inject more competition into the rail industry would ensure the industry of the revenues necessary to make the needed infrastructure and capacity investments.

The railroads' position is that, because they are part of a highly capital intensive industry whose marginal costs decline as use of its plant increases, railroads cannot be regulated under a "perfect competition" model. Instead, because much, but not all, of the railroads' traffic base faces competition from

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[1] The Railroad-Shipper Transportation Advisory Council (RSTAC), in its recently released "White Paper," recognized the importance of capacity and infrastructure investment to ensuring a rail network responsive to the needs of its customers.

other modes, railroads must be able to "differentially price" their services based upon demand — that is, they must recover the substantial joint and common costs of their networks disproportionately from their captive traffic.[2] In this regard, we note that many of the shippers at the hearings did not dispute the continuing need for some sort of demand-based differential pricing, and that no party at the hearings showed how the more aggressive access remedies — designed to produce lower rates and conform the industry more closely to a perfect competition model — would permit railroads to recover sufficient revenues to cover system costs and support reinvestment in the rail facilities that shippers require.[3]

On the other hand, the railroads have not satisfactorily addressed the shippers' basic complaints: that the rail industry has changed dramatically since 1980 as a result of significant railroad consolidations, system rationalizations, and greater carrier pricing and routing discretion. Although these changes have contributed to the efficiencies, cost savings, and improved earnings necessary

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[2] Inherent in the rail industry cost structure are large amounts of joint and common costs that cannot be attributed to particular traffic. Because railroads, under the current system, serve a mix of competitive and captive traffic, a carrier cannot recover an equal portion of those unattributable costs from all traffic. Accordingly, it has been generally accepted that a railroad must price its traffic differentially so as to recover a greater percentage of its unattributable costs from traffic with a greater demand for (dependency on) rail transportation. Under demand-based differential pricing, shippers with greater transportation alternatives are offered lower markups to keep their traffic (and their contribution to the carrier's unattributable costs) on the rail network. As a result of this form of pricing, captive shippers may actually pay lower rates than would be necessary if competitive traffic were driven from the rail system by a purely cost-based pricing system. *See, Coal Rate Guidelines*, 1 I.C.C.2d 520, 526-27 (1985), *aff'd sub nom. Consolidated Rail Corp. v. United States*, 812 F.2d 1444 (3d Cir. 1987).

[3] The shape and condition of the rail system that open access would produce is a significant issue that was not resolved at the hearings. The shippers assume that the replacement of differential pricing by purely competitive pricing would reduce the rates paid by shippers. The railroads, by contrast, would argue that, because their traffic base would shrink, the rates paid by those shippers that would continue to receive service would actually increase, even as overall revenues received by railroads would decline, because the overall traffic base from which costs would be recovered would be reduced. More specifically, carriers could be expected to seek to maintain an adequate rate of return by cutting their costs, which could include the shedding of unprofitable lines. Thus, it is quite possible that open access would produce a smaller rail system (although not necessarily a degraded one) that would serve fewer and a different mix of customers than are served today, with different types of, and possibly more efficient but more selectively provided, service.

We leave open to public discussion the issue of whether that type of a rail system, which might not serve shippers of less desirable traffic, would better serve the interest of shippers, labor, and the public generally. But we note that the industry's ability to earn revenue sufficient to maintain the existing extent of rail service does appear to depend to some degree on the use of differential pricing.

to sustain the industry, cumulatively the result has been a significantly more consolidated industry in which competitive options for rail-dependent shippers have not been expanded. This increasing consolidation within the industry, combined with the difficulties that many shippers perceive in obtaining relief through the regulatory system, leave too many shippers feeling that they have no leverage and no avenue of relief. In short, the shippers charge that, eighteen years after passage of the Staggers Act, the regulatory system is not functioning as intended; what has resulted, they claim, is a highly concentrated rail industry that is generally pleased with the present regulatory scheme, and a group of rail-dependent shippers, which our regulation is meant to safeguard, that feels unprotected and broadly discontented.

Whether seeking better service, better prices, or both, dozens of rail-dependent shippers and their trade associations appeared at the hearings to voice those sentiments. The railroad industry asserts that many shippers are largely satisfied with present-day rail service, and certain intermodal shippers — which ship highly competitive traffic — voiced their support for the regulatory status quo at the hearings. However, no rail-dependent shippers or shipper groups participated to express satisfaction with the present state of rail service. The Board cannot ignore the pleas of those many shippers that are concerned with the present state of affairs.

It is thus clear that we have reached a regulatory crossroads. Neither continuation of the status quo nor the immediate adoption of the more drastic measures suggested by some shippers (measures which, if not carefully implemented, risk completely undoing the progress made towards a healthy national railroad system capable of meeting customers' service needs) seems appropriate at this juncture. Therefore, we must take a careful, measured approach. We will start by accepting the offers made at the hearings by both rail industry and shipper representatives to reexamine certain aspects of our current regulatory scheme.[4] We will also institute appropriate rulemaking proceedings to re-examine other issues that we believe we can address now. Finally, we intend to report appropriately to Congress on the outcome of the hearings and

[4] Initial reliance on negotiations among the interest groups that are directly affected by our regulatory policies is neither inappropriate nor without precedent. In Ex Parte No. 456, *The Staggers Rail Act of 1980 — Conference of Interested Parties,* the ICC established a forum outside of the agency's purview to encourage railroads and shippers to discuss and negotiate solutions to disputes arising from the implementation of the Staggers Act, and to submit proposals for the agency's considerations. Our competitive access regulations, 49 CFR 1144 *et seq.*, discussed *infra*, are a product of that process.

our proposed administrative initiatives, and discuss in that report other possible actions.

We turn now to the specific issues that we believe immediately can and should be addressed administratively.

Revenue Adequacy

Congress has directed the Board to allow rail carriers to earn "adequate" revenues and to maintain standards and procedures for measuring such revenue levels. 49 U.S.C. 10101(3), 10704(a)(2). In implementing those directives, the ICC defined adequate revenues as those that provide a railroad a rate of return on net investment equal to the current cost of capital,[5] and the Board has continued to employ that standard.

At the hearings, several shipper interests asserted, as others have in the past, that the cost-of-capital standard, under which only a few Class I railroads have been found to have "adequate" revenues, fails to reflect the railroads' true, robust financial posture.[6] They argue that other financial measures — such as credit-worthiness, return on equity, or market-to-book value — show an industry that is doing quite well financially. The railroads, on the other hand, defend the continued use of the cost-of-capital standard, pointing to recent Wall Street reports that have questioned the industry's long-term viability in light of returns on investment less than that amount. At the hearings, representatives of both

[5] *Standards for Railroad Revenue Adequacy*, 364 I.C.C. 803 (1981), *aff'd sub nom. Bessemer & Lake Erie R. Co. v. United States*, 691 F.2d 1104 (3d Cir. 1982), *cert. denied*, 462 U.S. 1110 (1983).

[6] There seems to be a mistaken impression in some quarters that a railroad that is "revenue inadequate" under our standards has unfettered pricing freedom. To the contrary, a rate may be unreasonable even if charged by a carrier that is far short of revenue adequacy. *Coal Rate Guidelines*, 1 I.C.C.2d at 536-37. Under the stand-alone cost (SAC) test, a railroad's rate is limited to what a hypothetical efficient carrier would need to charge to provide the needed service to the complaining shipper while fully covering all its costs — without regard to the existing carrier's revenue levels. Likewise, under the simplified guidelines (available for those cases in which the SAC test is impracticable), even though we take into account a carrier's revenue need, there is no requirement that a carrier be "revenue adequate" before its rates can be found unreasonable. *Rate Guidelines--Non-Coal Proceedings*, 1 S.T.B. at 1016-17, 1019.

Once a carrier has become revenue adequate, however, shippers may prefer to apply the revenue adequacy constraint. Under this test, "captive shippers should not be required to continue to pay differentially higher rates than other shippers when some or all of that differential is no longer necessary to ensure a financially sound carrier." *Coal Rate Guidelines, Nationwide*, 1 I.C.C.2d at 535-36. Thus, when carriers are considered "revenue adequate," or when it can be demonstrated that inefficient operations are preventing the carrier from being considered "revenue adequate," an alternative to the SAC test may be available.

railroads and shippers advocated referring this issue to one or more disinterested expert economists with no preconceived position on the issue.

Notwithstanding the administrative proceedings that have already been held, the years of continuing debate, and the litigation that has already addressed this issue, we agree that a fresh examination would be useful. Accordingly, we request representatives of the shipping community and rail industry to meet, under the supervision of an Administrative Law Judge (ALJ), and select a mutually acceptable panel of three such disinterested experts to examine the current and alternative measures of a railroad's financial health, and to make recommendations to us as to the appropriate standard to apply.[7] We would then review the panel's recommendations and, if a new or revised standard is recommended, seek public comment on it.

We request the parties to organize, meet, and select a three-person panel by May 15, 1998. The panel, under the ALJ's supervision, may determine its own procedures, and should submit its report to the Board by July 15, 1998.

Competitive Access

Under the current statute, three kinds of competitive access remedies are available to complaining shippers or carriers. The first, and least physically intrusive form of access, is an *alternative through route* under 49 U.S.C. 10705(a), whereby an incumbent railroad can be required to interline traffic with another railroad and provide a through route and through rate for that traffic. The second form of access is *reciprocal switching* under 49 U.S.C. 11102(c), whereby the incumbent railroad, for a fee, must transport the cars of a competing carrier, enabling the latter carrier, even though it cannot physically serve the shipper's facility, to offer a single-line rate to compete with the incumbent's single-line service. The third, most intrusive form of access is *terminal trackage rights* under 49 U.S.C. 11102(a), whereby the incumbent railroad, for a fee, must permit physical access over its lines to the trains and crews of a competing carrier.

Although access to more routing options could provide additional competition in some circumstances, the statute does not provide these access remedies on demand; a showing of need is required. In implementing the directives of the Railroad Revitalization and Regulatory Reform Act of 1976 (4-R Act) and the Staggers Act, which ended the former shipper-directed "open

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[7] While we will provide the ALJ, we expect the parties to incur the costs for the panel of experts.

routing" system under which railroads had been required to establish extensive and not always efficient interchanges and through routes, the current regulations require a demonstration that the incumbent rail carrier has engaged in anticompetitive conduct. 49 CFR 1144.5(a). More specifically, they require a showing that the carrier has either (1) used its market power to extract unreasonable terms or (2) because of its monopoly position shown a disregard for the shipper's needs by rendering inadequate service.[8]

At the hearings, as in the past, some shippers complained that the "anticompetitive conduct" standard of the competitive access regulations is too onerous, effectively precluding use of the competitive access remedy in an increasingly consolidated rail industry in which shippers are facing service failures such as those now being experienced in the West. The railroads concur that the competitive access rules should be revisited as they pertain to service failures. To ensure that our procedures are effective in addressing needed service improvements, we will expeditiously begin a rulemaking proceeding to consider revisions to the competitive access regulations to address quality of service issues.

Given the changes that have taken place in the rail industry since 1980, we will also consider whether to revise the competitive access rules with respect to competitive issues that are not related to quality of service. First, however, we direct the railroads to arrange meetings with a broad range of shipper interests, again under the supervision of an ALJ that we will appoint, to explore the issue and see if the parties can mutually identify appropriate modifications to the non-service-related component of our standards that would facilitate greater access where needed.[9] We request the parties to report back to us on this issue by August 3, 1998.

Market Dominance — Product and Geographic Competition

Another area of continuing concern for rail-dependent shippers involves the difficulties associated with seeking rate relief from the Board, especially those difficulties posed by the components of our market dominance standards relating to product and geographic competition. Under the statute, the Board has jurisdiction to consider a rate challenge only if the carrier has market dominance

[8] *Midtec Paper Corp. v. Chicago & N.W. Transp. Co.*, 3 I.C.C.2d 171 (1986), *aff'd sub nom. Midtec Paper Corp. v. United States*, 857 F.2d 1487 (D.C. Cir. 1988).

[9] We suggest that the parties explore, for example, the proposal made by Illinois Central Railroad that each railroad designate certain "open" gateways on their systems that would be available for use by all shippers to create alternative through routes.

over the traffic involved, that is, if there is no effective competition for the traffic at issue. 49 U.S.C. 10707. In evaluating whether a railroad can exercise market dominance, the Board considers whether the shipper could obtain the transportation service that it needs from other railroads (intramodal competition) or other modes of transportation (intermodal competition). In addition to these direct competitive alternatives, the Board considers, when raised by a railroad, whether there is product or geographic competition that would effectively constrain a carrier's pricing. Product competition results from the availability of suitable substitute products that can be acquired without relying on the services of the same carrier. Geographic competition exists where the shipper can conduct its business by obtaining the product it needs from a different source and/or by shipping its goods to a different destination using another carrier. Shippers complain that the examination of possible product and geographic competition unduly complicates the market dominance determination and places an enormous litigation obstacle to a shipper's ability to pursue a rate complaint.

Plainly, the zealous use of the discovery process may be partly to blame for the heavy burdens associated with the inquiry into product and geographic competition in individual rate cases. We have, in a decision issued today, taken appropriate action to ensure that carriers — which have the burden both of identifying the existence of and proving the effectiveness of any product and geographic competition — not shift those burdens onto the shipper through unsupported and/or overreaching discovery demands. *FMC Wyoming Corp. & FMC Corp. v. Union Pacific RR Co.*, 3 S.T.B. 88 (1998).

While our action to curb discovery abuses may alleviate some of the shippers' concerns, we believe that it is also time to consider removing product and geographic competition altogether from the market dominance analysis. Initially, the ICC concluded that these issues complicate rate proceedings unduly. *See, Special Procedures for Making Findings of Market Dominance as Required by the Railroad Revitalization and Regulatory Reform Act of 1976*, 353 I.C.C. 875, 905-06, *modified*, 355 I.C.C. 12 (1976), *aff'd in relevant part sub nom. Atchison, T. & S.F. Ry. v. ICC*, 580 F.2d 623 (D.C. Cir. 1978). The ICC subsequently reversed course in *Market Dominance Determinations*, 365 I.C.C. 118 (1981), *aff'd sub nom. Western Coal Traffic League v. United States*, 719 F.2d 772 (5th Cir. 1983) (*en banc*), *cert. denied*, 466 U.S. 953 (1984),

concluding that consideration of these issues would be manageable.[10] Based on more than a decade of experience, we should now reconsider whether the ICC's initial conclusion was the better one. Accordingly, we will institute a rulemaking proceeding expeditiously to consider eliminating product and geographic competition from our market dominance analysis.

Smaller Railroads

An area of great concern for short-line railroads (and for the shippers that they serve) are obstacles — including "paper barriers" (contractual obligations incurred when short-line carriers acquired lines from larger, connecting carriers); inadequate car supply; and the lack of alternative routings — that prevent them from obtaining or fully using connections with competing carriers. At the hearings, shippers suggested that, in a more competitive rail environment, there should be a greater role for short-line railroads and other smaller carriers, particularly in rural areas. We agree that smaller railroads represent a potentially significant resource in addressing the issues that concern the shippers, and that to date their potential remains largely untapped.

At the hearing, we were advised that the smaller railroads and the large railroads have initiated discussions to address these concerns. Because we believe that private-sector solutions are generally preferable, we urge the parties to address and resolve these issues themselves, and to do so expeditiously. We direct the parties to report back to us on their progress in this regard by May 11, 1998. The Board is prepared to take administrative action as necessary and appropriate in this area to address the concerns that have been raised.

Formalized Dialogue

Another issue on which all sides agreed at the hearing was the need for greater communications, including more formalized discussions, between railroads and their customers. In addition to the forums that already exist to address issues of ongoing concern, such as the National Grain Car Council and the RSTAC, the railroads proposed to establish a regular, formalized process for discussions about service planning and needs, with the Board as an overseer

[10] *See also, Product and Geographic Competition*, 2 I.C.C.2d 1 (1985) (burden of proving product and geographic competition in market dominance cases shifted to railroads).

of the process.[11] In this regard, we remind railroads that their customers include both large and small shippers, and that they need to find a more systematic way of addressing customer concerns — related to rate and service issues and to means for obtaining relief — of small shippers as well as large ones. Additionally, we again remind the railroads that all of these initiatives will have effects on their employees, and we urge them to include rail labor in their discussions. We direct the railroads to report back to us on their progress in establishing formalized dialogue with shippers and with their employees, by May 11, 1998.

Board/Shipper Discussions

At the hearings, Board members expressed their willingness to meet with shippers to address general issues concerning railroad service. One shipper representative expressed concern about potential improprieties in the event that shippers were to meet informally with Board members. So long as shippers limit their discussions at such meetings to general service and other issues of broad concern, rather than specific pending cases, we welcome the opportunity to engage in dialogue with them.

This decision will not significantly affect either the quality of the human environment or the conservation of energy resources.

It is ordered:

1. The parties to this proceeding will take the actions described in this decision by the dates indicated above.

2. This decision is effective on April 17, 1998.

By the Board, Chairman Morgan and Vice Chairman Owen.

[11] Other matters that might be addressed at such discussion sessions include service performance standards and remedies or penalties that should apply when such standards are not met.