



## TRB Special Report 318: Modernizing Freight Rail Regulation

While the U.S. freight railroad industry has become modernized and financially stable since the Staggers Rail Act of 1980, some of the industry's remaining economic regulations have not kept pace and should be replaced with practices better-suited for today's modern freight rail system. More appropriate, reliable, and usable procedures are needed for resolving rate disputes; better data are required to assess railroad service quality; and certain functions left over from the previous regulatory era, such as regulators having responsibility for merger approvals, serve purposes that are no longer valid. The approaches recommended in this congressionally-requested report are intended to resynchronize a regulatory program that has become outdated.

### **Background:**

The Staggers Rail Act of 1980 eliminated or eased many regulations governing railroad pricing and operations and allowed railroads to redress decades-long declines in traffic, stagnant productivity, and oversized networks that had become chronically under-maintained and misaligned with demand. By the late 1990s, the Staggers Rail Act had succeeded in spurring the development of a financially stronger, more productive, and more innovative railroad industry that was better able to compete with trucks, invest in capacity, and respond flexibly to shippers' needs.

Thirty-five years after passage of the Staggers Rail Act, some shippers remain dissatisfied with the implementation of the regulatory program, believing that too much attention has been given to protecting the earnings of the railroads and too little attention given to ensuring that railroads supply responsive service at reasonable rates. Meanwhile, railroads remain concerned that the residual regulatory program will be altered in ways that threaten their ability to earn the revenues required to pay for their capital-intensive networks.

### **Why TRB conducted this study:**

In Fiscal Year 2012, Congress appropriated funds for "a comprehensive study of the Nation's railroad transportation system since the enactment of the Staggers Rail Act of 1980" that had been authorized in 2005. The study charge specifically calls for recommendations on the future role of the Surface Transportation Board (STB) in overseeing and regulating the service levels and rate offerings of railroads, particularly as they become revenue adequate.

To conduct the study, a seven-member committee was appointed consisting of experts in economics, regulatory policy, and freight transportation. The full committee includes: Richard L. Schmalensee, *Massachusetts Institute of Technology*, Chair; Kenneth D. Boyer, *Michigan State University*; Jerry Ellig, *George Mason University*; José A. Gómez Ibáñez, *Harvard University*; Anne V. Goodchild, *University of Washington*; Wesley W. Wilson, *University of Oregon*; and Frank A. Wolak, *Stanford University*.

### **Findings and Recommendations:**

#### ***Rate Relief: More Appropriate, Reliable, and Usable Procedures Are Needed***

While the Staggers Rail Act affords shippers with the ability to challenge unusually high rates, the committee found that the formula used to identify high rates is unreliable and economically invalid, leading to regulatory procedures that systematically deny large numbers of shippers access to the law's maximum rate protections. The problem lies with the law's requirement that regulators estimate the cost of transporting rail shipments when most railroad costs are shared by traffic and not traceable to the individual shipments under dispute. When the Staggers Rail Act was passed, all railroad pricing had been regulated, and hence there were no competitively determined rates that could serve as benchmarks for assessing the reasonableness of rates in markets with no effective competition. Three decades later, ample data on market-based rates are available for such purposes.

***The study committee recommends*** that Congress prepare for the repeal of the current formula for screening rates for eligibility for rate relief by directing the U.S. Department of Transportation to develop a more reliable screening tool that compares disputed rates to those charged in competitive rail markets. This tool would replace current methods that make artificial and arbitrary estimates of the cost of rail shipping.

Current adjudication methods can cost millions of dollars for litigation and some have taken years to resolve, deterring shippers with smaller claims from seeking rate relief. Simplified methods that are economically valid and practical to use have yet to be introduced. In effect, burdensome STB rate hearings compensate for an unreliable process for identifying unusually high rates. The system has the effect of safeguarding railroad revenues by making it too costly for most shippers to litigate a case. Shippers are thus denied equal and effective access to the law's maximum rate protections.

***The study committee recommends*** that STB hearings used to rule on the reasonableness of challenged rates be replaced with arbitration hearings that compel faster, more economical resolutions of rate cases. The committee also recommends that arbitrators be empowered to propose the remedy of reciprocal switching for those rates found to be unreasonable.

#### ***Annual Revenue Adequacy Determination Serves No Constructive Purpose***

The Staggers Rail Act requires STB to maintain standards and procedures for making annual determinations of whether the earnings of each of the Class I railroads is sufficient to attract capital. This annual pass/fail appraisal of revenue adequacy has become ritualistic while offering little substantive information for regulators and policy makers in monitoring the industry's economic and competitive conditions.

***The study committee recommends*** that STB discontinue issuing annual reports on the revenue adequacy of individual railroads and replace them with periodic studies of economic and competitive conditions in the industry.

#### ***Merger Review: The Legacy Public Interest Standard Is No Longer Justified***

Decades ago when the railroads were heavily regulated, they were exempted from customary antitrust reviews of the competitive effects of mergers by the U.S. Department of Justice and subjected instead to a broader public interest review by railroad regulators. Any such rationale for keeping the public interest standard no longer exists, since STB itself has stated that excess and duplicative capacity are no longer problems and that preserving competition among the remaining railroads will be the priority for future reviews.

***The study committee recommends*** the transfer merger review authority to the antitrust agencies and that customary antitrust principles rather than a public interest standard be applied in merger reviews.

#### ***Strategic Review of STB Data Programs with a Focus on Monitoring Service Quality***

Until the Staggers Rail Act, all railroad traffic was moved in common carriage, and all rates and other terms of service were publicly posted and to a large degree similar. The Act made it possible for railroads to supply service by private contract, but retained the obligation of railroads to respond to requests for common carrier service for some types of traffic. Regulators, however, do not have reliable means to monitor the railroad response. Regularly collected, usable data on service quality are needed for this monitoring function. In particular, shipment-specific data are needed to determine how the service provided in common carriage compares to that provided in contract carriage.

***The study committee recommends*** that STB give priority to the data needed to oversee the railroads' response to their common carrier service obligation by collecting and analyzing shipment-level data on service quality.

Since the passage of the Staggers Rail Act, the railroad industry has been transformed and modernized. The economic regulations that remain should be suited to the financially sound railroad industry of today, not to the foundering one that required rescue 35 years ago. The modernization proposed in this report would reduce the anachronistic regulatory burdens railroads still bear while giving more shippers real protection against unreasonable rates. It would continue the process begun by the Staggers Rail Act—a process aimed at producing a modern, efficient, and competitive railroad industry able to attract capital, maintain and expand its capacity, and serves its customers with a minimum of regulatory oversight.

The study was sponsored by the U.S. Department of Transportation. The National Academy of Sciences, National Academy of Engineering, Institute of Medicine, and National Research Council make up the National Academies. They are private, independent nonprofit institutions that provide science, technology, and health policy advice under a congressional charter granted to NAS in 1863. The National Research Council is the principal operating arm of the National Academy of Sciences and the National Academy of Engineering. For more information, visit <http://national-academies.org>.