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**RAILROAD ACCESS IN THE TWENTY-FIRST  
CENTURY FROM THE CLASS I RAILROAD PERSPECTIVE**

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# **RAILROAD ACCESS IN THE TWENTY-FIRST CENTURY FROM THE CLASS I RAILROAD PERSPECTIVE**

Richard A. Allen

## **INTRODUCTION**

One of the most contentious issues between most railroads in the United States and many of their customers at the threshold of the twenty-first century is the issue of “competitive access.” This paper will discuss that issue, primarily from the perspective of the Class I U.S. railroads); it will describe the various aspects of the issue, the current state of the law with respect to it, various proposals for changing the law, and the arguments for and against those proposals.

What is “competitive access?” Broadly speaking, it is the ability of railroad customers that are currently served by only one railroad to obtain competitive service from other railroads. The issue of competitive access is obviously most acute for sole-served shippers, *i.e.*, shippers that are served only by one railroad and have no feasible transportation alternatives (*e.g.*, by trucks or water carriers). The issue does not often arise with respect to transportation by trucks, water carriers or airlines, which serve their customers by means of public highways, waterways and airways freely available to all competitors. It does arise frequently with respect to railroads, which serve their customers by means of very expensive tracks and rights of way that can usually be used only by the owning railroad or with its permission.

Generally speaking, there are three ways a sole-served shipper can get competitive access to other railroads: by alternative through routes, by reciprocal switching and by trackage rights. Perhaps the easiest way to understand each of these is by reference to a hypothetical example.

Suppose S is a coal-fired electric utility whose plant is located just outside Mobile, Alabama and is served exclusively by the tracks of a large eastern railroad (Eastern 1). Suppose

S receives its coal from mines in the Powder River Basin in Wyoming that are served by two large western railroads (Western 1 and Western 2), which can transport the coal from those mines to any of several interchange points with Eastern 1, including Chicago, St. Louis, Memphis or New Orleans. Suppose also that Mobile is served by two other large eastern railroads (Eastern 2 and Eastern 3), which can also interchange with the western railroads at the same interchange points. Suppose finally that Eastern 1, wishing to handle as much of the movement as possible on its own lines, offers a rate for the movement only through a Chicago interchange (say, \$2000 per car for its portion of the haul), and refuses to “switch” any coal cars to the plant that are brought to Mobile by Eastern 2 or Eastern 3. Since coal deliveries to the plant must use the tracks of Eastern 1 and since trucks and barges are not feasible alternatives for the movements, Eastern 1 can demand a significantly higher rate for handling its portion of the haul than it could if other railroads could also serve the plant and thereby provide competitive alternatives.

As noted, there are three principal ways S could gain competitive access, or, at least, improve its competitive situation. The first is by an alternative through route. If S could require Eastern 1 to interchange with the western railroads at New Orleans, only 100 miles from Mobile, rather than at Chicago, S would probably be better off. Because there is head-to-head competition between Western 1 and Western 2, the rate from the Powder River Basin to New Orleans will probably be lower than if there were no competition, and since the segment from New Orleans to Mobile is fairly short, Eastern 1’s rate for that segment is likely to be much less than its rate for the Mobile-Chicago segment; consequently, the total rate for the entire through movement through a New Orleans interchange is likely to be much less than the rate through a Chicago interchange. Strictly speaking, forcing an alternative through route is not “competitive

access,” but it can often improve the shipper’s competitive situation by making a much longer portion of the haul subject to competition. It should be noted, however, that forcing such a change in the interchange point would not guarantee lower rates for S, because, at least in theory, Eastern 1 could charge the same \$2000 per car rate for hauling cars from New Orleans that it charges for hauling them from Chicago.

The second way of gaining competitive access is by mandating “reciprocal switching.” Switching is a term that refers to the movement of cars over relatively short distances (usually within a “switching district”) for a flat rate per car. Typically, carriers have uniform switching rates (*e.g.*, \$250 per car) for moving cars for other railroads within a switching district. Switching is distinguished from line haul movements; carriers participating in multi-carrier line haul movements receive portions of the through rate that varies from rate to rate.<sup>1</sup> Switching is termed “reciprocal” if all the carriers serving a switching district agree to switch for each other at the same switching fee, but switching need not be reciprocal. Carrier A can offer switching at a flat rate for Carrier B even if Carrier B does not offer switching services for Carrier A. Generally, carriers are not legally required to offer switching services, and if they choose to do so, they can set the switching fee at whatever level they wish (subject to the statutory requirement that all rates and charges by railroads not exceed a reasonable maximum).

In our example, S could obtain a form of competitive access if it could force Eastern 1 to switch coal cars brought to Mobile by Eastern 2 or Eastern 3 (*i.e.*, take them from some point in Mobile where Eastern I can interchange with the other carriers, usually a rail yard, to S’s plant)

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<sup>1</sup> If the through rate is a single “joint rate” established by the participating carriers, each carrier’s division of that rate is negotiated between them. If the through rate is comprised of separately established local or proportional rates, each carrier’ portion is unilaterally established by itself.

for a per car fee set by a regulatory agency.<sup>2</sup> In that case, virtually the entire length of the haul, from the PRB to Mobile, would be subject to competing alternative routes, and the competition between the carriers would tend to produce lower rates. Eastern 1, by having to take the cars the short distance to their destination for a low, fixed fee, would not be able to exploit its exclusive physical access to the plant by charging what the economists call “monopoly rents.” This form of competitive access is generally more effective than forcing alternative through routes, but it is not perfect, because the compelled carrier (Eastern 1 in our example) can make it an unattractive option for S simply by providing poor switching service.

The third, and probably most effective, means of gaining competitive access is by mandated trackage rights. If S could compel Eastern 1 to allow Eastern 2 or Eastern 3 or both to operate over Eastern 1’s tracks between interchange points in Mobile and S’s plant at a trackage rights fee set by the regulatory agency, S would enjoy direct service by competing alternative routes for the entire length of the haul. Even this form of competitive access is not perfect, because Eastern 1, as the owner of the trackage rights tracks, will normally retain the right (and responsibility) for dispatching trains on the tracks (*i.e.*, saying which trains can go and when), and can thereby make the service of its competitors more difficult. The practical ability of dispatching railroads to discriminate against their trackage rights tenants in this fashion, however, is fairly limited.

As the number of large railroads in the United States has gone down dramatically over the past three decades as the result of major consolidations, shippers and shipper groups have pressed Congress and the regulatory agency (the Surface Transportation Board and its

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<sup>2</sup> Although this form of access is generally referred to as “reciprocal” switching, that is a misnomer, because there is nothing necessarily reciprocal about it. One carrier is simply (continued...)

predecessor, the Interstate Commerce Commission) with increasing vehemence to authorize and mandate more competitive access than the law and regulatory policy now provides. Most railroads, and especially the large railroads, have opposed those efforts, arguing with equal vigor that increased competitive access in the forms urged by shippers would radically change the structure of the U.S. rail industry and would seriously threaten the financial viability of U.S. railroads.

I will now summarize the existing law and regulatory policy respecting competitive access, the principal proposals for change and the arguments for and against such changes.

### **Existing Law and Regulatory Policy Regarding Competitive Access**

**1. Alternative Through Routes.** 49 U.S.C. § 10703 requires connecting railroads to “establish through routes (including physical connections) with each other” and to provide “reasonable facilities for operating the through route.” This provision requires connecting railroads to establish at least one through route and one point of interchange for movements traversing their lines. However, if connecting carriers have, by agreement among them, established one through route for an interline movement, as a general rule they will not be required to establish other through routes; the choice of through routes and interchange points is generally for the carriers to decide, with exceptions about to be discussed.

The STB has *authority* under 49 U.S.C. § 10705(a)(1) to prescribe additional through routes and associated rates and rate divisions when it considers them “desirable in the public interest,”<sup>3</sup> but in 1985, the ICC adopted rules stating that it would exercise its authority under

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required to provide switching services.

<sup>3</sup> 49 U.S.C. § 10705(a)(1) provides: “The Board may, and shall when it considers it desirable in the public interest, prescribe thorough routes, joint classifications, joint rates, the division (continued...)”

§ 10705, as well as its authority to prescribe reciprocal switching under 49 U.S.C. § 11102, only in limited circumstances. These rules, often referred to as the “Competitive Access Rules” or “CARs”, were established in *Ex Parte 445, Intramodal Rail Competition*, 1 I.C.C.2d 822 (1985), *aff’d sub nom. Baltimore Gas and Electric v. United States*, 817 F.2d 108 (D.C. Cir. 1987), and they are codified at 49 C.F.R. § 1144.5. Those rules provide that the Board will not prescribe new through routes, rates or switching arrangements whenever, and merely because, it concludes that doing so would create more efficient routes or more competitive arrangements for shippers. Instead, they provide that the Board will do so only if it determines: “(1) That the prescription or establishment (i) is necessary to remedy or prevent an act that is contrary to the competition policies of 49 U.S.C. 10101a or is otherwise anticompetitive, *and* (ii) otherwise satisfies the criteria of 49 U.S.C. 10705 and [11102].” 49 C.F.R. § 1144.5(a) (emphasis supplied). In other words, under the rules, a party asking the Board to prescribe new through routes, through rates and reciprocal switching arrangements must show much more than that the circumstances satisfy the statutory criteria; the party must also show that the prescription is needed to remedy or prevent specific anticompetitive acts by the railroads involved. The ICC and STB cases show that the latter showing is a very difficult one for shippers to make, and they have rarely succeeded. *See, e.g., 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).<sup>4</sup>

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of joint rates, and the conditions under which those routes must be operated, for a rail carrier providing transportation subject to the jurisdiction of the Board under this part.”

<sup>4</sup> With respect to alternative through routes, CARs established a regulatory regime significantly different from that prevailing before the Staggers Rail Act of 1980. As described by the court in *Baltimore Gas and Electric*, 817 F.2d at 110-111, by the mid-1970’s, the rail industry had evolved into a system of “open routing” in which railroads were effectively required to establish and maintain interchanges and through routes “on practically (continued...)”

In 1996 and 1997, the STB issued decisions known as the *Bottleneck Cases* that established important corollaries to the rules on alternate through routes.<sup>5</sup> In those decisions, the Board reaffirmed the principle that, if connecting carriers have established an efficient through route for an interline movement, the Board will not require them to establish other routes unless the shipper makes the showing required by the CARs. It also held that if one carrier has a single-line route from origin to destination, it is not required to establish interline routes for the same movement with other carriers or to offer rates applicable to such interline routes. If the movement must be handled by more than one carrier and if the participating carriers have established an efficient through route and have agreed upon a single joint rate for the entire through move, the shipper cannot require the “bottleneck carrier” (Eastern 1 in our example) to establish local or proportional rates applicable only to its segment of the route that the shipper could separately challenge as unreasonable. The Board reaffirmed the long-established principle that shippers are entitled only to challenge the reasonableness of the rate or rates applicable to the entire shipment; they may not challenge the reasonableness of rates applicable to segments of a through movement.

In *Bottleneck II*, the Board created one exception to the foregoing holdings, applicable to cases in which the shipper has entered into a transportation contract with a non-bottleneck

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all possible combinations of railroad tracks between two points.” This system was not based on the ICC’s view that carriers have a general legal duty to establish all possible through routes (*see, e.g., Routing Restrictions Over Seatrail Lines*, 296 I.C.C. 767, 774 (1955), stating that carriers had no such duty). Instead, it grew up as a result of the ICC’s routinely imposing DT&I conditions in rail mergers and of the ICC’s general unwillingness to permit carriers to cancel through routes once they had been established.

<sup>5</sup> *Central Power & Light v. Southern Pacific Transportation Co.*, 1 STB 1059 (1996) (“*Bottleneck I*”), modified in part, 2 S.T.B. 235 (1997) (“*Bottleneck II*”), *aff’d sub nom.* (continued...)

railroad from the origin (or destination) to a reasonably efficient interchange point (*e.g.*, in our example, a contract with Western 2 for movement from the PRB to New Orleans). In such a case, the bottleneck carrier is required to quote a rate from the interchange point to the destination, which rate could be separately challenged at the STB. Neither carrier can dictate the interchange point to the other, but if they cannot agree, the Board will select the interchange point based on the comparative efficiencies of alternative routes and interchange points. The Eighth Circuit upheld the Board's rulings except for the contract exception, which the court found not ripe. *MidAmerica Energy Company*. The District of Columbia Circuit later upheld the contract exception in a case in which it was applied. *Union Pacific R. Co. v. STB*, 202 F.3d 337 (D.C. Cir. 2000).

**2. Reciprocal Switching Arrangements.** 49 U.S.C. § 11102(c)(1) provides that “[t]he Board may require rail carriers to enter into reciprocal switching agreements, where it finds such agreements to be practicable and in the public interests, or where such agreements are necessary to provide competitive rail service. . . . [I]f the rail carriers cannot agree upon [the] conditions and compensation within a reasonable period of time, the Board may establish such conditions and compensation.”

Although this statutory authority to prescribe reciprocal switching arrangements is very broad, as noted earlier, the Board in the CARs ruled that it would do so only where a requesting party has made a showing that a railroad had engaged in specific anticompetitive acts. Such

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*MidAmerican Energy Co. v. STB*, 169 F.3d 1099 (8<sup>th</sup> Cir. 1999), *cert. denied*, 528 U.S.950 (1999).

anticompetitive conduct, the agency has said “can take many forms.”<sup>6</sup> In *Midtec Paper*, the ICC rejected the shipper’s claim that a railroad had violated the standard, and said: “[W]e were attentive to the possibility of classical categories of competitive abuse: foreclosure; refusal to deal; price squeeze; or any other recognizable forms of monopolization or predation. We also considered whether there was any evidence of abuses under the competitive standards of the Rail Transportation Policy, including inadequate service or excessive prices. Under either approach, we found none.” 3 I.C.C.2d at 173-174.<sup>7</sup>

**3. Mandated Trackage Rights.** 49 U.S.C. § 11102(a) provides: “The Board may require terminal facilities, including mainline tracks for a reasonable distance outside of a terminal, owned by a rail carrier . . . to be used by another rail carrier if the Board finds that use to be practicable and in the public interest without substantially impairing the ability of the rail carrier owning the facilities . . . to handle its own business. . . [I]f the rail carriers cannot agree, the Board may establish conditions and compensation for use of the facilities under the principle controlling compensation in condemnation proceedings.”

Again, this provision gives the Board broad authority to require one railroad to grant another the use of terminal facilities and “mainline tracks for a reasonable distance outside of a terminal.” However, although the CARs did not address the standards for granting such terminal trackage rights, in *Midtec Paper* the ICC held that the same standards establish by the CARs

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<sup>6</sup> *Rio Grande Industries, Inc., et al. – Purchase and Related Trackage Rights – Soo Line Railroad Company Line Between Kansas City, MO and Chicago, IL*, 1989 ICC LEXIS 351 at \*33 (ICC served November 13, 1989) (“*Rio Grande/Soo*”)

<sup>7</sup> Interestingly, Canadian law requires railroads in Canada to provide switching for each other at rates set by the Canadian Transportation Agency in all cases where the origin or destination of a movement is within 30 kilometers (18 miles) of an interchange point. Canadian Transportation Act, § § 127 and 128, and Railway Interswitching Regulations.

should be applied to requests for terminal trackage rights. Thus, in addition to the criteria of § 11102(a), a party must show that the issuance of terminal trackage rights is needed to remedy specific anticompetitive acts by the owning railroad. I am not aware of any case in which the ICC or STB found that such a standard has been met.

Even if the requisite showing of anticompetitive conduct were met, the STB statutory authority to grant trackage rights over a railroad's lines to other railroads is limited to terminal facilities and mainline tracks for a reasonable distance outside terminals. The ICC held that a "terminal area" is any property of a carrier that assists in the "transfer, collection or delivery of freight." *Rio Grande/Soo* at \*26. In that case, the agency expressed considerable doubt, without deciding, that a 42-mile segment of track constituted either a terminal area or mainline tracks for a reasonable distance outside a terminal area. In *Golden Cat Division of Ralston Purina Company v. St. Louis Southwestern Ry. Co.*, 1996 STB LEXIS 132 (STB served April 25, 1996), the STB held that a shipper's facility in a rural area was not a "terminal facility." The STB said: "There are no major communities, switching or classification yards, or shippers other than GCRP located at or anywhere near the . . . facility. It is not a 'cohesive commercial area.' To define the . . . facility as a terminal facility would be to broaden the term to embrace any shipper facility." 1996 STB LEXIS at \*18.<sup>8</sup>

Although the STB's authority to impose trackage rights under § 11102(a) is limited to terminal areas and surrounding tracks and is, in any case, limited by the CARs, it has broad authority in the case of railroad mergers and acquisitions to impose trackage rights on the merging parties as a condition to the Board's approval of the transaction; and it has frequently

done so. In its 1996 decision approving the merger of the Union Pacific and Southern Pacific rail systems, for example, the Board, over the applicants' objections, granted some 300 miles of trackage rights to the Texas Mexican Railway over UP and SP lines between Beaumont and Corpus Christi, Texas, and it approved an agreement in which UP granted more than 4000 miles of trackage rights to the Burlington Northern Santa Fe Railroad.

The purpose of imposing trackage rights as conditions in rail consolidation cases has been to preserve competition that would otherwise be lost as a result of the transaction, and in all consolidation cases to date, the Board's policy has been to impose trackage rights or other conditions only to the extent needed to preserve competition. Its policy has been against imposing such remedies for the purpose of enhancing competition over what it was prior to the consolidation.

The Board recently changed that policy when, in June 2001, it promulgated new rules to govern future major consolidations. *Ex Parte No. 582 (Sub-No. 1), Major Consolidation Procedures*. Served June 11, 2001. The Board's new policy, codified at 49 C.F.R. § 1180.1(d), states:

The Board anticipates that mergers of Class I carriers would likely create some anticompetitive effects that would be difficult to mitigate through appropriate conditions, and that transitional service disruptions might temporarily negate any shipper benefits. To offset such potential harms and improve the prospect that their proposal would be found to be in the public interest, applicants should propose conditions that would not simply preserve but also enhance competition.

Decision at 30. Although the Board asserted that its "primary" focus in imposing conditions in future major rail merger cases "should and will continue to be remedial," (*id.* at 31), its decision

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<sup>8</sup> As to what would qualify as "mainline tracks for a reasonable distance outside of a terminal," in *Midtec Paper*, the ICC noted that it had found that tracks as long as 13 miles outside a (continued...)

clearly signals the possibility that it may also impose trackage rights and other conditions not just to remedy identifiable merger-related competitive harms but also to *enhance* competition beyond pre-transaction levels (or, which amounts to the same thing, that it may disapprove applications which do not themselves offer up enough such enhancements.)

This is a very significant change in Board policy. Moreover, since the ways the agency could enhance competition are virtually unlimited, it is difficult to see how the agency could ever impose a competition-enhancing condition without being arbitrary and capricious. Unless it were to grant all the competition-enhancing conditions sought by shippers and other parties in a case, any decision to impose some but not others (thereby favoring some parties but not others) would seem necessarily arbitrary.<sup>9</sup>

The STB's new merger policy, in addition to reflecting a general skepticism that future major rail mergers in the United States will provide net public benefits, seems to represent a concession to shippers and their allies who have been contending that the Board has not done enough to promote rail competition, perhaps in the hopes of forestalling various more extreme measures that have been proposed -- a subject to which I now turn.

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terminal qualified. 3 I.C.C.2d at 179.

<sup>9</sup> The fact that the Board's new policy encourages the applicants themselves to offer up competitive enhancements (by threatening disapproval if they don't) does not mitigate the fundamentally arbitrary character of the new policy. It merely forces the applicants, rather than the Board in the first instance, to fashion enhancements and arbitrarily distribute them to some favored shippers and communities but not to others. Furthermore, prospective merger applicants will have no way of knowing in advance how large an "enhancement" price they will have to pay to gain the agency's approval of their transaction.

## **Proposals to Enhance Competitive Access Through Legislative or Regulatory Change.**

For years, shippers and shipper groups have advocated various changes in the law or regulatory policy designed to enhance competition among railroads and to enhance competitive access. For the most part, the rail industry has opposed these proposals. Some of them, the railroads argue, would seriously threaten the financial viability of U.S. railroads. To date, Congress has not made any major changes of the kind urged by shipper groups, although at least one bill that would do so, described below, is now pending. The last major changes to the statute governing railroad regulation were in 1976 (the 4-R Act) and 1980 (the Staggers Rail Act of 1980). These changes significantly reduced regulation of the U.S. rail industry, and they are widely credited with the dramatic recovery of that industry over the past two decades from a state of near collapse to a state of reasonable financial health and greatly increased tonnage and operational efficiency.

In 1998, at the request of Senator McCain, Chairman of the Senate Commerce Committee, and Senator Hutchinson, Chairman of the Subcommittee of Surface Transportation and Merchant Marine, the STB conducted hearings and considered written comments on the subject of railroad competitive access and other competition issues. In a decision served on April 17, 1998, the Board concluded:

It is . . . 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. 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. We will also institute appropriate rulemaking proceedings to reexamine other issues that we believe we can address.

*Ex Parte No. 575, Review of Rail Access and Competition Issues*, Decision served April 16, 1998 at 3.

With respect to the issue of competitive access, the Board said it would consider whether to revise the CARs, but it first directed the railroads “to arrange meetings with a broad range of shipper interests . . . 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.” *Id.* at 4. Such meetings were held, but the shippers and railroads failed to reach any agreement. Accordingly, on December 21, 1998, STB Chairman Linda Morgan reported to Senators McCain and Hutchinson as follows:

The differences between the railroads and the shippers on the Board’s competitive access rules are fundamental, and they raise basis policy issues—concerning the appropriate role of competition, differential pricing, and how railroads earn revenues and structure their services—that are more appropriately resolved by Congress than by an administrative agency. . . . For those reasons, . . . the Board does not plan to initiate administrative action to otherwise revisit the competitive access rules at this time.

Letter at 4. In a footnote, Chairman Morgan indicated some serious concerns about changing the existing regulatory system concerning competitive access. Among other things, she noted that “unless smaller railroads were able to fill in service gaps that could be created, open access could produce a smaller rail system that would serve fewer shippers, and a different mix of customers, than are served today, with different types and levels of, and perhaps more selectively provided service.”

The leading proposals for change now pending before Congress are contained in S. 1103, a bill introduced on June 26, 2001 by Senators Rockefeller, Dorgan and Burns. With respect to competitive access and enhancing railroad competition, S. 1103 would do the following:

- It would amend 49 U.S.C. § 11102(a), regarding terminal trackage rights, and 49 U.S.C. § 11102(c), regarding reciprocal switching, by providing in both cases that, in making any

determinations under those provisions, “the Board may not require evidence of anticompetitive conduct by a rail carrier from which access is sought.” This would overrule the key requirement of the CARS and the *Midtec* decision, and it would probably have to be interpreted to require the Board to grant terminal trackage rights and reciprocal switching arrangements whenever it found that doing so would be operationally feasible and would enhance railroad competition. This would appear to come close to a system of complete open access.

- It would specifically overrule key aspects of the STB’s *Bottleneck I* and *Bottleneck II* decisions (as well as the long line of precedents on which they were based) by requiring any rail carrier, upon request of a shipper, to “establish a rate for transportation and provide service requested by the shipper between any two points on the system of that carrier where traffic originates, terminates, or reasonably may be interchanged.” This would not only return to the system of open routing in effect until the mid-1970s, where shippers dictated the routings, but also would allow the shipper to challenge the reasonableness of the rates required to be established, even though they pertain only to one segment of a through route.
- In future major merger cases, it would provide that the “Board shall impose any conditions that the Board considers appropriate to encourage and expand competition between and among rail carriers in the region affected by the transaction or in the national rail system.” This would require at least what the Board has established in its new merger rules for major transactions, and it may well go beyond those rules by effectively requiring the Board to impose any competition enhancing conditions that are operationally feasible.

The arguments of Senator Rockefeller and other proponents of these measures are straightforward: rail mergers over the last few decades have reduced the number of large

railroads to a handful of monopolists or quasi-monopolists who have been providing poor service at non-competitive prices to many of their customers; these measures would greatly increase competition among railroads; and the more competition among railroads, the better for the public.

The railroads advance two sorts of arguments in opposition to S. 1103 and similar proposals. The first are based on economics and logic. Although these arguments are probably correct, they are not as readily understandable by, or persuasive to, the man in the street as the shippers' arguments because, at bottom, they seek to defend uncompetitive situations and noncompetitive pricing.

The second type of arguments, which to me are more persuasive, are based on experience: in brief, the current regulatory regime has produced the most efficient and competitive rail system in the world, and therefore we'd be foolish to make fundamental changes to it.

The economic arguments run as follows: railroads are a capital-intensive industry with large economies of scale and density. Most of their traffic is subject to intense competition from trucks, water carriers and pipelines. The competition for that traffic requires railroads to price their services for it at close to their marginal costs. Because of their large capital costs and economies of scale, the railroads' marginal costs are far below their fully allocated average costs. Therefore, if all their traffic was priced at competitive levels (*i.e.*, near marginal cost), the railroads couldn't cover their costs and would go out of business.<sup>10</sup> The only way railroads can

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<sup>10</sup> A prime example of these forces at work is railroad passenger transportation. After the appearance of widespread intercity automobile, bus and airplane travel, trains could not begin to cover their average cost of carrying passengers. Continued obligatory transportation of passengers would have driven the private railroads out of business if Congress had not (continued...)

cover their full costs is to be able to engage in “differential pricing,” a term which means the ability to charge more for traffic that is not subject to competition than if that traffic were subject to competition. If railroads were required to make their lines available to competitors in all cases where they can now engage in differential pricing – as S. 1103 would require them to – then they could not engage in differential pricing and would go out of business.

By and large, the STB, like the ICC before it, has agreed with these arguments and has accepted the necessity of railroad differential pricing. The CARs are essentially premised on the correctness of these propositions, as is the stand-alone-cost test that the STB employs to measure the reasonableness of rail rates. The difficulty with selling these propositions to many shippers and to the general public is that they seek, in effect, to justify uncompetitive situations and the right of railroads to charge noncompetitive rates to captive shippers.<sup>11</sup> These arguments may be right, but intuitively they are not very appealing.

The arguments from experience run as follows: the pre-4R Act/Staggers Act regime of heavy regulation of the railroad industry brought the industry to the verge of extinction in the 1970’s, with many railroads going bankrupt and the rest barely hanging on. Deregulation, which gave the railroads much greater freedom as to pricing, investment and de-investment (*i.e.*, line abandonments), has revitalized the industry and given the United States the most efficient and competitive rail system in the world. Railroads point out that rail traffic has increased about 50 percent since 1980 as measured by revenue ton miles, and yet average rail rates have *fallen* by

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created Amtrak to take over that function, and Amtrak has never covered its operating costs, much less its fully allocated costs.

<sup>11</sup> It is also difficult to explain why railroads must be able to charge “differential” prices when other transportation providers, like trucks and barges, do not and cannot. The simplest (continued...)

almost the same percentage in real terms over roughly the same period.<sup>12</sup> Despite declining average rates, deregulation has allowed railroads to improve their productivity even more, resulting in increased profitability. Increased profits and opportunities for profit have in turn lead to dramatic increases in investments in railroad infrastructure. Capital investments by Class I railroads increased from under \$20,000 per track mile in 1983 to almost \$40,000 per track mile in 1996 in 1983 dollars.<sup>13</sup>

Railroads also point out that despite the improvements brought by deregulation, railroads still have a long way to go. In terms of return on equity, railroads remained at the bottom quarter of industries examined by Fortune magazine in 1998,<sup>14</sup> and in its most recent revenue adequacy determination, served July 31, 2001, the STB found that no Class I railroads were revenue adequate (*i.e.*, were covering their cost of capital) for the year 2000. In the face of these facts, the railroads argue, it would make no sense to re-regulate the industry in the manner proposed by S. 1103, which would effect fundamental changes in the regulatory regime and seriously, and perhaps fatally, reduce their revenues and profits.<sup>15</sup>

Another argument from experience the railroads make is to point out the problems experienced by other countries that have opted for a rail system of open access in an effort to

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answer is that trucks and barges did not construct the highways and waterways they use to serve their customers.

<sup>12</sup> Comments of the Association of American Railroads filed March 26, 1998 in STB. Ex Parte No. 575 (hereafter "AAR Comments") at 12, 24.

<sup>13</sup> AAR Comments at 21.

<sup>14</sup> AAR Comments at 23.

<sup>15</sup> Senator Rockefeller solemnly asserts that S. 1103 "is not an attempt to re-regulate the railroad industry," (statement of Senator Rockefeller on the Senate floor, June 26, 2001), but it is difficult to imagine that he could seriously believe that claim.

promote competition among rail service providers. The prime example is Britain, which privatized its national rail system by separating the ownership of the underlying track and roadbed from the operating companies. According to the AAR's experts, virtually no competition among operating companies has resulted, spending on infrastructure and maintenance has been inadequate, productivity is far less than the productivity of U.S. railroads and freight rates are more than four times higher per ton-kilometer than U.S. freight rates.<sup>16</sup> In contrast, the rail systems of Argentina and Mexico, which privatized their state-run railroads on the U.S. model, have shown very dramatic improvements in service and investments.<sup>17</sup>

The experience in this country since the 4R and Staggers Acts and the experience of countries like Britain, Argentina and Mexico seem to me to demonstrate the truth of what I find the most persuasive argument in favor of the present regulatory regime concerning competitive access, which is simply this: any system of rail regulation that either separates the ownership of the infrastructure from the provision of service or that requires the owner of the infrastructure to share it with the owner's competitors is bound to provide inadequate or inappropriate incentives to investment in the infrastructure and to prevent the most efficient use of that infrastructure. Take the example of the Dakota, Minnesota and Eastern Railroad, which wants to spend a billion dollars or so building a new rail line into the Powder River Basin to partake of some of the profits that BNSF and UP have enjoyed hauling coal out of the Basin for the past 20 years. Can anyone seriously imagine that DM&E would have been willing to undertake that investment, with all of its associated risks, under a regulatory regime that required it to share its line with a

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<sup>16</sup> AAR Comments at 35.

<sup>17</sup> AAR Comments at 32-33.

competitor, even if the competitor were required to pay a usage share of the construction and maintenance costs?

The best system, it seems to me, is one that maximizes the railroads' incentives to make investments (or disinvestments) in response to, and commensurate with, the demand (or lack of demand) for its services. Any regime that forces a railroad to make its facilities available to competitors on terms set not by the railroad but by a regulator, or that limits what it can charge to some amount set by a regulator (as in the case of mandated reciprocal switching) undermines or distorts those incentives. At some point (for example, where a market dominant railroad charges more than stand-alone costs), limiting the railroad's pricing freedom or its exclusive right to use its facilities may be appropriate. But short of that point, the experience of the past several decades demonstrates that regulatory system should leave the decisions about how to use railroad property to the persons who make the investment in it.