Effects of U.S. Rail Deregulation on Pricing Activities of Canadian Railroads

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ABSTRACT

The U.S. Congress, in an effort to assist the country's railroad industry that was suffering from a restrictive and outdated regulatory system, passed legislation aimed at revitalizing the troubled industry. In passing the Staggers Rail Act of 1980, Congress introduced deregulation to the railroads, granting them the freedom that allowed them to operate in a more competitive environment. The revised regulatory structure has had widespread implications for the pricing strategies of both U.S. and Canadian railroads. The effects of the U.S. rail deregulation on the pricing activities of both U.S. and Canadian railroads are examined in this paper. The railroad industry in Canada had operated under considerable price freedom since the National Transportation Act was passed in 1967. U.S. railroads, in comparison, appeared to be overregulated and increasingly unable to compete with other modes of transportation. Legislation passed in the 1970s was unsuccessful in creating the stimulus the railroads required. The Staggers Act did indeed relax many of the rail carriers' obligations, but it also drastically curtailed the degree of antitrust immunity the industry had enjoyed for many years. The railroads have been forced to operate in a much more competitive manner since October 1980, and contracts and rebates are becoming commonplace. The Canadian railroads have been forced to respond to the revival of competition south of the border or risk losing a significant proportion of their international traffic. Deregulation has also had legal ramifications for Canadian carriers because the laws governing the movement of freight traffic in the two countries are now in conflict. There is a distinct possibility that the Canadian railroads will lose their immunity to anticombines laws, an event that has already occurred in the United States.

The Staggers Act has created conflict between Canadian and U.S. railroad regulations in a number of areas. In this paper the major differences in the legislative framework of the two countries and how these differences have affected the pricing of international freight traffic originating in Canada are examined. Three major areas are examined: (a) the Canadian railroads' response to American competition and price freedom; (b) complications of participation in through rates and routes because of surcharges, cancellations, and rebates; and (c) antitrust implications of deregulation for Canadian railroads.

CANADIAN RAILROAD PRICING SINCE U.S. DEREGULATION: A CASE STUDY

Changes in pricing policies since U.S. deregulation have not been limited to U.S. railroads. Canadian carriers have been forced to take action of a competitive nature to avoid a significant erosion of their market share of U.S. traffic. Shortly after the Staggers Act was passed in October 1980, U.S. railroads began an overhaul of their freight rate structure that resulted in many rates being reduced. A significant number of these rate reductions applied to points in Canada served by a U.S. carrier or to border points that could easily be reached by a Canadian shipper.

Canadian railroads were then faced with a situation where many origins they served had published rates that were lower than their own if the traffic was routed on a U.S. carrier that had filed an independent tariff. In order to protect their share of international traffic, Canadian railroads were forced to publish competitive rates. It was assumed that this competition would be beneficial to shippers; however, such was not necessarily the case. The reasons will become clear from the following case study.

The British Columbia forest industry is heavily dependent on the United States as a market for its products. Of the 8.9 billion board feet (fbm) of lumber exported from British Columbia in 1980, 6.3 billion fbm, or 71 percent, went to the United States (J.G. Black, "Impact of U.S. Rail Deregulation on the Forest Products Industry of British Columbia," paper presented to the Council of Forest Industries, Vancouver, British Columbia, October 6, 1981). Of that amount, 78 percent moved by rail. The distance from the source of production to the major consuming areas makes transportation costs a critical factor in the ability of British Columbia lumber producers to market their product competitively. For this reason the industry has been directly affected by U.S. rail deregulation, as well as by the Canadian response to the new environment.

This particular analysis includes a review of the traditional international freight rate structure and a discussion of new tariffs that have been brought into effect since deregulation. A summary of reaction from the industry to the breakdown of traditional rate relationships is presented.

The Transcontinental Freight Rate Structure

Lumber shipments by rail from British Columbia and the U.S. Pacific northwest have customarily moved under rates published by the Trans-Continental Freight Bureau (TCFB). These rate structures have been in existence for approximately 75 years and provide the basis for all transcontinental commodity movements originating in western Canada and the United States. The rates are based on origin groups, which are blanket zones covering large geographical areas. Rates from points within an origin group are identical, which has led to some interesting anomalies.

For example, the Coast Rate Zone, or group 1, extends from Prince Rupert, British Columbia, all the way down the west coast to the California border. Because all points in this group take the same rate basis, a shipper in Prince Rupert pays the same freight rate as a shipper in Portland, Oregon, 700 miles to the south.

The origin zones under the TCFB rate structure are shown in Figure 1. It is apparent that the rates in the Coast Zone were predicated on responding to potential water competition from the west coast to the east coast. The British Columbia Rail Rate Zone was established in the 1950s, long after the original TCFB rate structure. It reflects the degree of captivity of shippers along the line, and because there is no competition from water carriers, rates are somewhat higher than the Coast basis. The Interior and Inland rates were once higher than the Coast Zone rates; however, because water competition has diminished, the Coast rates are now generally higher than the Interior rates.

One of the functions of a rate bureau is to provide a forum for collective rate making and division hearings. Independent action by single carriers was traditionally unheard of and, until recently, unnecessary. The Staggers Act changed all that. Under U.S. rail deregulation, carriers are encouraged, indeed required, to take independent action on single-line rates. Collective discussion is no longer permitted because of the extended application of antitrust laws. At the same time, a number of U.S. railroads were embarking on ambitious acquisition programs that facilitated the development of single-line through rates.

Competitive Railroad Action

Taking advantage of the deregulated environment, the Burlington Northern (BN) substantially lowered its rates on lumber from Washington and Oregon to points in Southwestern Lines territory. Included in this reduction were points in British Columbia served by the Burlington Northern--specifically Vancouver and Nelson, a town in the southern interior just north of the U.S. border. The new rates resulted in reductions of up to $1,400 a carload on lumber from Vancouver to Dallas, Texas, a city at the center of one of the fastest growing markets for lumber.

The new rates lowered transportation costs by up to $21 per thousand board feet from Vancouver. This is equivalent to a 25 percent reduction. The magnitude of this reduction was sufficient to divert a substantial amount of lumber traffic normally handled on Canadian railroads to a U.S. carrier. Canadian railroads were not slow in responding to this

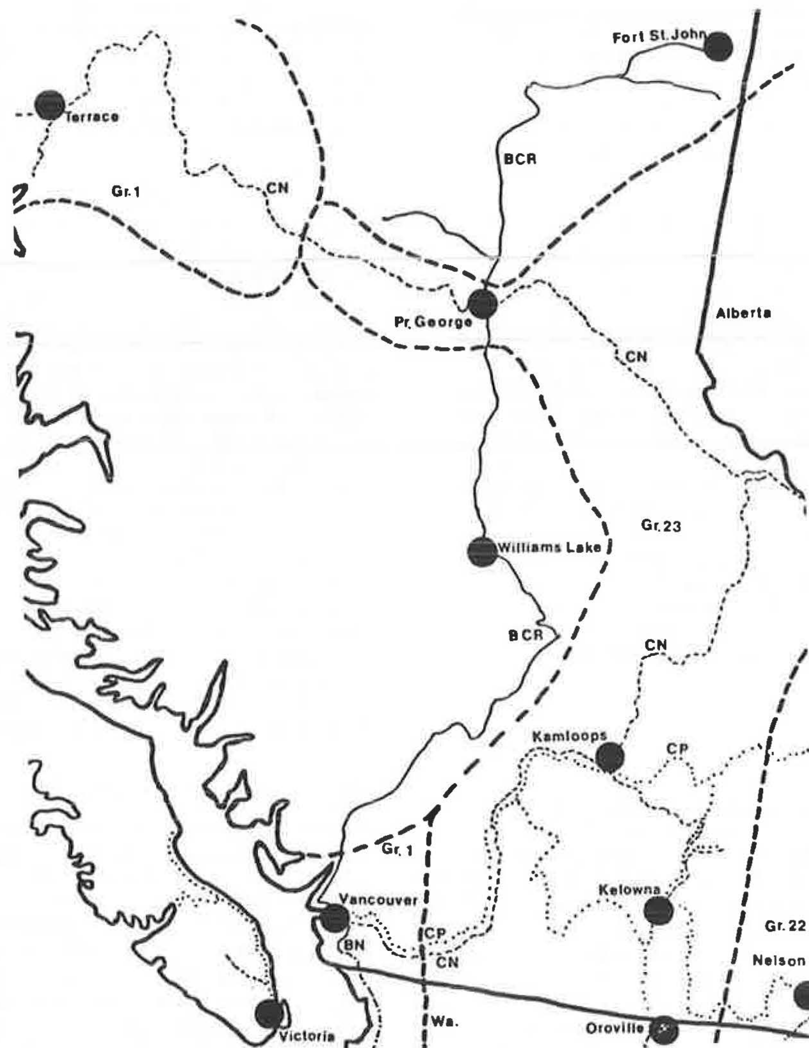

FIGURE 1 Map of origin zones under TCFB rate structure.

threat. Within weeks of the publications of the BN tariff, both Canadian National Railways, through the Canadian Freight Association (CFA), and Canadian Pacific West (CPW) issued tariffs that contained rates structured to minimize any erosion of market share. A comparison of the rates published in these tariffs, as well as those in the BN and TCFB tariffs, is given in Table 1.

TABLE 1 Comparison of TCFB and Special Rates to Dallas[a]

Origin	TCFB 4518 ($)	BN 4494 ($)	CFA 4105[b] ($)	CPW 4025[b] ($)
Vancouver	5,731	4,323	5,115	4,771
Terrace	5,731	–	5,340	–
Portland, Oreg.	4,746	4,323	–	–
Prince George	5,621	–	5,230	–
Kamloops	5,621	–	4,955	4,837
Kelowna	5,621	–	4,955	4,579
Nelson	4,467	3,960	–	3,976
Oroville, Wash.	5,621	3,960	–	–
Williams Lake	6,072	–	5,450	–
Ft. St. John	5,775	–	5,450	–

Note: Dash = not applicable.
[a]Based on 110,000 lb per car.
[b]As of January 1, 1982.

The overall result of this rate action was a major reduction in freight rates on lumber from points in British Columbia to destinations in Texas. It would have appeared that these reductions would be welcomed by the industry. This was not the case. If there is anything the lumber industry resists more than a rate increase, it is a restructuring of rates that alters existing rate relationships between mills. Therefore, although the new tariffs reduced the rates from all British Columbia origins to Texas, they lowered rates from some origins more than from others. The result was a distortion of the traditional rate relationship that had existed between mills throughout the province. The former rate structure tended to minimize factors such as distance and cost in the rate, resulting in a variation in freight rates of only about $100 per car on Canadian National Railway origins. This rate scale allowed mills in the northwestern area of the province to remain competitive, on the basis of transportation costs, with mills located in other areas of the province much closer to the market.

Deregulation in the United States brought the traditional rate structure to an end. The rates published by CN and CP in their respective tariffs were based on meeting the competition from U.S. carriers, and therefore the distance factor could no longer be ignored. Although rates from all origins throughout the province were reduced, those geographic points considered most vulnerable to U.S. competition benefited the most.

Reaction of Shippers

Major protests against the new rate structure came from producers in the northwest corner of the province. The parity that formerly existed between this area and other parts of the province was removed under the new, competitive rate structure. If producers in this area were forced to pay freight rates based on cost- and distance-related factors, their ability to compete with southern British Columbia producers would be considerably eroded. Reaction from the producers in this area was swift. Representatives of mills attempted to point out the effects on their operations that would result from the newly implemented rate structure. A summary of their concerns follows.

1. Traditional rate relationships have been disrupted so the net effect is that northwestern British Columbia mills are now at a rate disadvantage compared to Vancouver and Prince George mills.
2. These transportation penalties, unless rectified, will cause further deterioration of the northwestern mills' ability to compete effectively in the North American markets.

Although the overall reduction in freight rates was acknowledged, the mills' concerns were the result of some of their competitors' rates having been reduced even further.

Matters of this type also normally involve the Transportation Committee of the British Columbia Council of Forest Industries (COFI). Comprised of representatives of most companies in the British Columbia forest industry, the Council is a body whose aim is to present a unified viewpoint on areas of concern to members. U.S. rail deregulation and its effects on the British Columbia forest industry are a matter that clearly has varying ramifications for different members of the industry. Although deregulation is proving to be beneficial to some members of the industry, the protest noted previously indicates that it may be difficult for the Council to maintain unanimity in its negotiations with the railroads. In its 1981-1982 annual report the Council acknowledges that

> One result of deregulation is the gradual breakdown of traditional rate relationships and parity. In response to this situation, the Transportation Committee has been considering a proposal to restore some sort of rate structure that would reflect to a certain extent competitive factors, location, and historical rate relationships. This process is underway with all sectors of the British Columbia forest industry considering various proposals. Without such a structure, it is expected that traditional rate-making practices would completely break down, and many sectors of the forest industry would suffer (1,p.12).

This statement correctly identifies the problem but not the solution. It is correct in its assertion that traditional rate-making practices have probably come to an end, but, although a new rate structure will indeed be based on competitive factors and location, it is unlikely that historical rate relationships will play a significant role in the new era. The number of blanket zones taking the same rate is likely to diminish. The new structure will likely cause greater emphasis to be put on a producer's locational advantage, a factor that the traditional rail freight rate structure minimized. The long-term outcome of the restructuring of rates may well be an overall adjustment of current marketing strategies by shippers who may find that certain markets become inaccessible to them if their product is transport-cost sensitive.

JOINT INTERNATIONAL TARIFFS

One of the casualties of the Staggers Act was the method by which shippers were kept informed of changes in rates and routes. Before deregulation, for any given origin and destination pair, there was usually only one rate charged regardless of the route the car was shipped on. This system did not

provide much incentive for rate competition between carriers although service was used as a means to solicit traffic. The situation was also less complicated for the traffic manager because any rate changes made were applied equally by all carriers serving the territory. Finally, rate bureaus, by approving all rate changes and overseeing publication of all tariff supplements, ensured uniform knowledge of tariffs throughout the industry.

The Staggers Act changed these procedures. By stripping rate bureaus of much of their authority and allowing carriers to take independent action through surcharges or route cancellations, the U.S. Congress changed the rules of operation. In their drive to encourage competition in the railroad industry, the legislators created considerable confusion. It is now extremely difficult for both shippers and carriers to be fully aware of what rates are available on a particular route. The issue has been further complicated by the growth of contract rates with confidential rebates. The result is that no one, other than the parties directly involved, knows the effective rate being paid for a particular service.

The new U.S. legislation creates further difficulties for Canadian railroads because it conflicts with a number of provisions of Canadian railway law. For example, when a U.S. carrier surcharges its portion of a joint international route, Section 286 of the Canadian Railway Act requires that the surcharge be filed with the Canadian Transport Commission (CTC) because the surcharge affects an international tariff. Furthermore, a Canadian carrier is permitted to collect only those rates that have been filed with the CTC. After the passage of the Staggers Act, it was observed that a number of U.S. carriers were surcharging their portion of an international movement but were not notifying other carriers and were not filing the surcharge with the CTC. This situation made it difficult for Canadian carriers originating the international traffic to quote the correct rate to the shipper, and even more difficult to collect the full transportation charge, because the entire amount had not been filed with the CTC. After receiving a number of complaints from shippers paying more than they anticipated on a cash-on-delivery shipment, the Canadian railroads notified their U.S. counterparts that they "were unwilling and unable to collect their surcharges and we suggested that they collect these surcharges at their own stations" (J.L. DiFruscia, "U.S. Rail Deregulation Update," paper presented to the Council of Forest Industries, Vancouver, British Columbia, October 6, 1981, p. 8).

Another provision of the Staggers Act that comes into conflict with the Railway Act is Section 208--Contracts. By permitting rebates on both interstate and international movements, the Staggers Act is in direct conflict with Section 380 of the Railway Act, which states explicitly that rebates are illegal in Canada because railways cannot receive nor can shippers pay anything other than the published rate in the tariff. U.S. contract legislation is also in conflict with Section 286 of the Railway Act, whereby a joint international tariff must be filed in its entirety with the CTC.

An example of some of the problems faced by Canadian carriers under the conflicting legislation is given in the following scenario. A shipper in Canada is quoted a rate from the joint international tariff for a move from a western Canadian origin to Chicago. The shipper is then approached by one of several U.S. carriers who provide service on the Duluth to Chicago portion of the route. The U.S. railroad offers the Canadian shipper a discount on the through rate if the car is routed on his road. This may take place without the knowledge of the Canadian carrier. A second Canadian shipper, competing with the first for the Chicago market, discovers it is losing business because it can no longer compete with the shipper receiving a rebate. The U.S. carrier may be unwilling to give the second shipper the same rebate the first receives because the second shipper cannot guarantee the same volume.

The second shipper, who feels discriminated against, may appeal to the CTC under Section 23 of the National Transportation Act. The likely outcome would be the enforced cancellation of all joint international rates, to be replaced by proportional rates to the border. Carriers south of the border would be free to deal with Canadian shippers on a contractual basis as long as there was no participation by Canadian railways.

The deregulated U.S. environment results in a confusing array of rates and routes for traffic managers to analyze. Managers have to determine which routes on an international move are higher than the published rate because of surcharges, which are lower because of rebates, and which may have been cancelled altogether. The ability of producers to maintain their competitive positions in certain U.S. markets will depend on their aptitude for searching out the most efficient and economical route to that market. The proportion of rail transportation cost in a product's delivered price will be subject to wide variation, depending on the traffic manager's ability to negotiate freight rates.

ANTITRUST IMPLICATIONS FOR CANADIAN RAILROADS

Perhaps the greatest impact felt by the Canadian railroads and shippers as a result of the Staggers Act is in the area of antitrust law. The Reed-Bulwinkle Act of 1948 protected members of the U.S. rate bureaus from the provisions of the Sherman antitrust laws. Because Canadian railroads were parties to the bureaus, they were indirectly afforded the same protection. Under Canadian railway legislation, rail carriers are permitted, and in some cases compelled, to set rates jointly without violating anticombines law.

Section 219 of the Staggers Act, which restricts the activities of rate bureaus, has cast a shadow of doubt over the practices of Canadian railroads in setting international rates. To fully appreciate the dilemma that now exists, three aspects of the problem need to be understood:

1. The extraterritorial application of U.S. antitrust law,
2. The effects of such application on the rate-making practices of Canadian railroads, and
3. The response of Canadian railroads and shippers to the cancellation of antitrust immunity.

Extraterritorial Application of U.S. Antitrust Law

The first question that comes to mind when discussing U.S. antitrust laws is why Canadians should be concerned about them at all. It would appear to be a logical conclusion that commercial activity that takes place entirely in Canada among non-U.S. citizens be subject to Canadian, not U.S., legislation. Considering that the Canadian transportation industry generally operates entirely in Canada, it would appear somewhat presumptuous of the United States to impose its laws on the commerce of Canada.

The simple answer to this question is that the U.S. antitrust laws are extraterritorial in scope. Actions taken in a foreign country may be within the

scope of the antitrust laws where the effect of the activity is felt on import commerce into or export commerce out of the United States (J.W. Ongman, "U.S. Anti-Trust Ramifications for the Canadian Transport Industry," paper presented to the Canadian Transportation Research Forum, 1982, p. 5). Considering that between 25 and 35 percent of Canadian railroads' revenues are derived from transborder traffic, a major portion of the industry could conceivably come within the scope of U.S. antitrust legislation. The acid test for jurisdictional reach is whether the consequences of any discussion will have an effect on U.S. consumers. Considering the proportion of transportation costs in a Canadian commodity's U.S. delivered price (more than one-third in some cases), there is little doubt that the criteria for application have been met.

The issue of extraterritorial application is not a recent development by any means, and the principle extends beyond the transportation industry. In the 1945 case, U.S. v. Aluminum Co. of America et al., the Supreme Court held that a cartel scheme entirely among non-American firms and operating in Europe would fall within the jurisdiction of the U.S. Sherman Act if the scheme's intent were to restrain trade in the United States. The court left no doubt as to its opinion by stating that U.S. laws have jurisdiction over foreign corporations irrespective of whether such corporations' actions are contrary to their own government's commerce legislation.

This brief discussion of U.S. jurisprudence and its extension to non-U.S. citizens underlines the quandary that Canadian railroad pricing officers have found themselves involved in since the passage of the Staggers Act. If they protect themselves from the new U.S. legislation, Canadian railway personnel are unable to abide by the Canadian Railway Act and Transport Act, which requires joint consultation on all traffic from competitive points. Although joint rate making continues on domestic traffic, discussion of international rates among Canadian carriers has been abandoned.

Effects on Pricing Activities

When an industrial sector the size of the railroads has operated under a particular set of circumstances for more than a century, the transition to an entirely new legal structure is not easy. In deciding how to respond to the antitrust dilemma, Canadian railroad officials asked themselves two questions:

1. Do the U.S. antitrust laws indeed apply to the Canadian railroads?
2. Assuming they do, and until such an issue is resolved, which activities are still considered legal and which are thought to be in doubt?

The termination of antitrust immunity with regard to international traffic was completely unanticipated by all parties affected. The policy of Canadian railroads was and still is that collective rate making is "absolutely essential to the efficient transfer of goods by rail from Canada to the United States, and has been viewed as an essential mechanism for reconciling the transportation policy of Canada with that of the United States" (comments of Canadian Railroads before the Interstate Commerce Commission, November 26, 1980, p. IV-12).

The curtailment of rate bureau immunity combined with the extraterritorial application of U.S. antitrust laws has created an entirely new set of complications for the Canadian railroad industry. It has contributed to consternation among pricing officials who find themselves forced to obey two conflicting sets of rules. It has hampered negotiations with U.S. carriers who are reluctant to participate in any activity that could be construed as a violation of the antitrust laws. The eventual outcome may be the gradual erosion of international through rates, their replacement by proportional rates to the border, and higher total freight rates.

REACTION OF THE CANADIAN TRANSPORTATION INDUSTRY

When the laws of one country are suddenly applied to activity that is conducted in another country, a vigorous protest from the latter is to be expected. When it became clear that the combined effect of the Staggers Act and the Interstate Commerce Commission (ICC) 5b Decision would be the abrogation of antitrust immunity for all international traffic, reaction from the Canadian shipping and transportation community was swift.

Submissions were made to the ICC by both major Canadian railroads, the government of Canada, and various shipper organizations. Shortly after the passage of the Staggers Act, Canadian National and Canadian Pacific Railroads make a joint presentation to the ICC; that presentation included testimony of senior marketing officers of each company as well as that of independent, expert witnesses. In his remarks to the Commission, R.C. Gilmore, Vice President, Marketing and Sales, CP Rail, outlined the implications of the rescission of antitrust immunity for Canadian railroads:

> The vast preponderance of Canadian railroads' traffic base consists of basic bulk commodities which are shipped from a number of geographically disperse origin points to an even larger number of destination points. The transportation realities of these commodities cannot be well served by point-to-point rates. Rather, rate groupings with inherent rate relationships are required in order to permit these commodities and the shippers of these commodities to compete in the destination markets. However, if antitrust immunity for collective actions is revoked the railroads will be powerless to prevent the dissolution of these rate structures (C.S. Stark, "A View of Current International Anti-trust Issues," paper presented at World Trade Institute Seminar on Advanced International Anti-trust Practices and Related Trade Issues, May 20, 1982, p. 35).

In their presentations both CN and CP reiterated the benefits of collective negotiation for both shippers and railroads. They pointed out the consequences for shippers with plants located in geographically remote areas who would find themselves increasingly disadvantaged in the destination markets as traditional rate structures broke down.

The underlying emphasis throughout the submission by the railroads was on the disruptive effect of the termination of antitrust immunity on the carriers, the shippers, and the market. Although the presentations successfully demonstrated the consequences for Canadian producers and railroads, there was little evidence in the presentations to indicate the potential adverse impact on the U.S. consumer. Because the consumer is the one with whom the legislators and administrators are most probably ultimately concerned, unless it can be clearly demonstrated that the new regulatory structure will have a negative effect on this sector of the economy, it is doubtful that the Commission's decision will be

altered. The ICC does not concern itself with the plight of producers in remote areas of Canada who can no longer compete in certain markets in the United States.

It is unlikely that the decision to revoke antitrust immunity from collective rate making will be changed to protect the U.S. consumer. It is likely that there will be significant disruption in international commerce, that traditional rate structures will be eroded, and that some producers may suffer. If the overall effect of increased competition is perceived to benefit the U.S. consuming public, any pleas from affected Canadian concerns will most probably be ignored.

CONCLUSION: WHITHER COLLECTIVISM?

The underlying theme of this paper has been a comparison of the Canadian and U.S. systems of railroad regulation and a discussion of how recent changes in the latter have influenced activities in the former. The issues are complex and the ramifications are widespread, but they can be summarized as follows.

1. The Canadian regulatory structure, basically unchanged since the National Transportation Act was passed in 1967, has allowed railroads considerable pricing freedom and has contributed to a financially strong and competitive Canadian railroad industry.
2. U.S. railroads, in contrast, were overburdened by an outmoded regulatory framework and found themselves hampered by regulations that were causing them to lose more and more traffic, contributing to a serious deterioration of the country's entire railroad industry.
3. As a result of pressures to save the industry from total bankruptcy, and coinciding with a general trend toward deregulation of U.S. industry, the Staggers Rail Act of 1980 was passed granting virtually complete pricing freedom to railroads. The result was a move toward more innovative and competitive pricing schemes in the United States, a trend that affected the Canadian railroad industry as well.
4. Deregulation ended the antitrust immunity enjoyed by railroads operating through rate bureaus. The application of the antitrust laws was extended to all traffic terminating in the United States, even if it originated outside the country.
5. As a result of this extraterritorial application of U.S. antitrust law, collective rate making by Canadian railroads on international traffic is in jeopardy.

Rarely has a piece of legislation been passed in the United States that has had such significant implications for a Canadian industry, in both the pricing and the legal arenas. Canadian railroads have reacted to the new environment in a competitive manner, reducing rates where there was potential erosion of market share.

The complications caused by the antitrust laws, combined with the lack of support for rate bureau immunity from a number of Canadian shipper organizations, has probably had the most deleterious effect on rate-making practices in Canada. Although the future of collective rate making by the Canadian railroads is in some doubt, it is probably safe to assume that there will never be a return to the level of immunity that existed before U.S. deregulation. Canadian shippers indicate, however, that industry opinion regarding this matter is divided.

REFERENCE

1. Council of Forest Industries of British Columbia. Annual Report of the Northern Interior Lumber Sector, 1981/82. Victoria, British Columbia, Canada, March 1982.

Publication of this paper sponsored by Committee on Application of Economic Analysis to Transportation Problems.

Evaluation of FAA's Economic Analysis Guide

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ABSTRACT

FAA's 1982 "Economic Analysis of Investment and Regulatory Decisions--A Guide" was reviewed for its effectiveness in determining the economic desirability of aviation-related project investment and regulatory alternatives. The FAA Guide was found to be excellent because it is (a) a comprehensive tool for analyzing investment and regulatory alternatives, (b) based on sound transportation economic concepts, (c) direct in approach, (d) easily understood, (e) well organized, and (f) not likely to become outdated because updating procedures are provided. Major weaknesses are (a) unavailability of important references that are cited, (b) lack of examples to assist users' understanding, and (c) reliance on potentially numerous hand calculations. The FAA Guide recommends the treatment of intangible and quantifiable nonuser benefits and costs in the benefit-cost analysis; the reviewer, however, recommends that the benefit-cost analysis include only quantifiable aviation user benefits and project or regulatory costs.