Competition Policy for U.S. Freight Railroads

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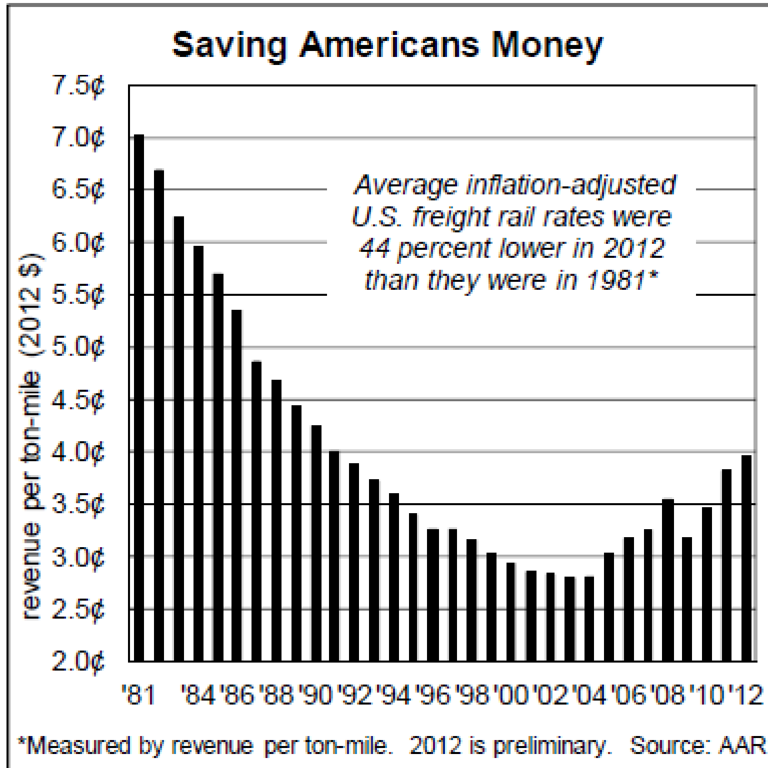
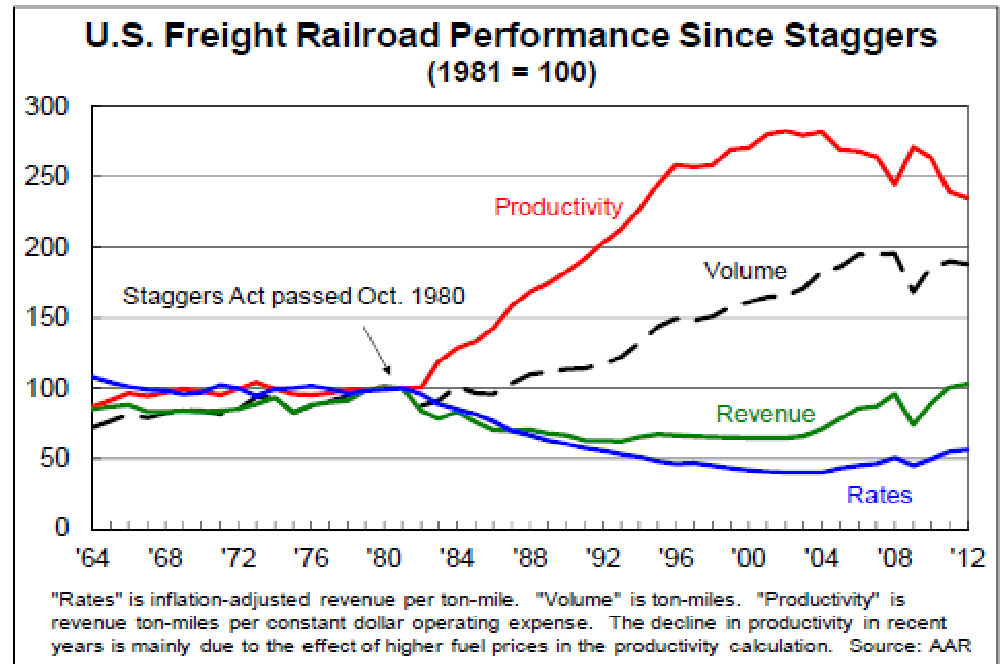
The views expressed are those of the presenter, and are not purported to reflect the views of the U.S. Department of Justice.

Staggers Act of 1980

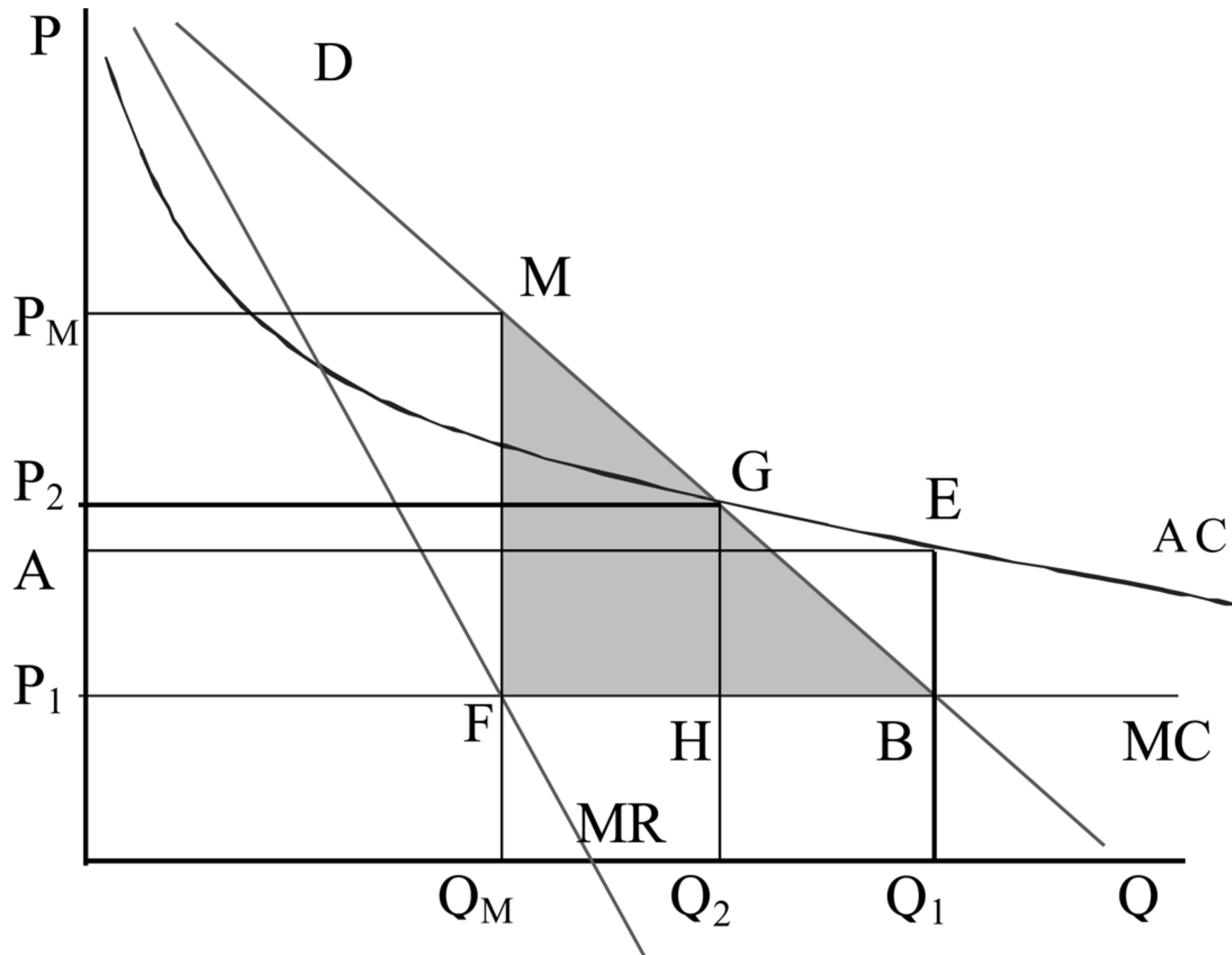
- Eased abandonment
- Encouraged mergers
- Substantially deregulated freight rates
  - "Contract rates" between railways and shippers unregulated
  - ICC (now STB) could deregulate rates for entire commodity classes: "intermodal", boxcar, many agricultural products
  - Remaining rates potentially regulated if railroad has "market dominance"
    - P/MC > 180%
    - Stand-Alone-Cost Test

Result: Everybody wins, for a while…





… But the problem of covering high fixed costs doesn't go away



Ramsey pricing is ONE efficient solution…

- 3rd degree Pigovian price discrimination
- Price based on elasticity of demand
- Higher prices to shippers with more options risks driving them off the rails, resulting in shippers with fewer options paying more, not less
- Still, undeniable that some shippers are paying much more of the fixed and common costs of the system than others.
- Thus…

… Should there be limits to Ramsey pricing?

- Option 1: Sherman and Clayton Acts
  - We break for a Public Service Announcement: Getting rid of antitrust exemptions is arguably good policy in general
- Likely 3 principal applications
  - Paper barriers
  - Refusals to deal
  - Mergers
- Option 2: Stand-Alone Cost Test
  - Price ceiling for "captive shippers"
  - Designed to prevent their "cross-subsidizing" other shippers

Antitrust (1): Paper barriers

- Railroads prefer to call them "interchange commitments"
- Line sell-offs to class II or class III lines accompanied by exclusive dealing restriction (or incentives)
  - Certainly limit competition in some cases
  - But are sometimes a financing device for deal – restrictions would likely reduce sell-offs
- Application of antitrust jurisprudence would likely limit these, especially in timeframe
- But STB seems to be moving to limit already

Antitrust (2): Refusals to deal

- Shippers demand either trackage rights or reciprocal switching to competing long-haul railroad
  - One example: Canadian system
- But antitrust jurisprudence rarely finds refusal to deal a violation
  - In general a seller "has a right to deal, or refuse to deal, with whomever it likes" (*Monsanto*)
  - Requires enforcement of terms of deal – long-term quasi-regulation
- Major disadvantage: requires willingness of other duopolist (usually) to "deal"

Antitrust (3): Mergers

- Transfer jurisdiction and standard from STB ("public interest") to courts ("substantially to lessen competition")
- Now that U.S. class I's form regional duopolies, would this make it more difficult to block a transcontinental merger?
- STB has already toughened standards, requiring affirmative showing of public benefits of merger (*Major Rail Consolidation Procedures*, 2001)

“Constrained market pricing”: The Stand-Alone Cost Test

- The founding text: Faulhaber, “Cross-subsidization: Pricing in public enterprises,” *American Economic Review* 1975.
- The model: multiproduct firm, high level of common costs, profit constrained, efficiently managed, operating in contestable market.
- Then *game-theoretic equilibrium* requires that no set of products be priced higher than the cost of producing that set of products alone: their stand-alone cost.
- Why? Two important reasons:
  - If P>SAC for some users, inefficient (“bypass”) entry induced.
  - If P>SAC for some users, it *necessarily follows* that some other P<IC – that some set of products is priced lower than the incremental cost of producing that set of products alone, so that one set of users is “cross-subsidizing” another. (Note that IC ≠ MC.)

But what does this test measure?

- Heald (1997): "Ambiguity stems from the virtual impossibility of constructing unequivocal and uncontested benchmarks for … determining whether there is cross-subsidy in particular cases."
- Borrmann and Zauner (2004): "There is a fundamental ambiguity…. Is cross-subsidy about *fairness* or about *market entry*?"
- Faulhaber (1975): Not about fairness; subsidy-free prices "do not necessarily promote the common weal or bring about social justice."
  - Faulhaber (2005): "In non-regulated enterprises, …The focus of cross-subsidy analysis shifts entirely to the IC tests. The SAC tests are not helpful under conditions of positive economic profits."
- Baumol: The SAC test "might better have been called its entry-inducing rate level."

Faulhaber (2011): "The question becomes, not is SAC the correct standard … but whether it can be effectively implemented in a regulatory context."

- At STB, parties have litigated:
- Whether a one-year, ten-year, or twenty-year SAC analysis is most appropriate;
- Whether expected average productivity improvements in freight railroads generally should be applied without adjustment to the SARR, or whether, since the SARR would be *ex hypothesi* newly built and so at the frontier of productivity, whether such industry-wide improvements should be factored in only gradually (and if gradually, how gradually);
- Whether culverts designed to substitute for bridges would be built with sufficiently wide entryways;
- How many acres of the farmland adjacent to the SARR would require seeding;
- Whether train "dwell times" at points of traffic interchange should be assumed to be 30 minutes, 45 minutes, 60 minutes, or 90 minutes;
- When new information becomes available, "whether we [the STB] can continue to examine the reasonableness of the challenged rate within the framework of the prior SAC analysis, or whether we should instead vacate the rate prescription and dismiss this proceeding so that a new and different SAC analysis can be presented in a new proceeding."

What is this SAC test all about?

- Fairness?
  - Faulhaber says no; Baumol/Panzar/Willig (1982) hint yes
  - But "fairness" seems to raise different issues, including degree of cost pass-through by customers
- Prevention of inefficient entry ("bypass")?
  - Faulhaber and Baumol say yes
  - But incumbent should guard against this anyway
- "Simulation" of competitive market? (BPW)
  - Sounds good, but what does it mean?
  - In particular, what are welfare consequences?

Is stand-alone cost a scientific-sounding diversion from the real issues?

- By definition, dividing common costs is a somewhat arbitrary exercise
- Ramsey pricing (like multi-part tariffs) is an "efficient way" to handle, but is it "fair"?
- In the US, most captive traffic is coal.
  - Bulk chemicals are second, grain third (STB)
- What is the "fair" way to divide economic rents among coal companies, railway companies, and electricity companies (and their workforces, and ultimately electricity customers)?

What is the “fair” way to divide economic rents? (continued)

- Difficult to say, but probably has very little to do with how many acres of farmland adjacent to a SARR would require seeding
- Removing antitrust exemptions may be good policy, but seems unlikely to make a big difference in this context
- P/VC ceiling?
  - STB’s VC measurement is standardized, used for multiple purposes, continuing to be improved
  - P/VC ceiling has been used as remedy in some SAC cases
  - The least bad way of protecting captive shippers without “re-regulating” railroads?