

Regulation, Deregulation, and Reregulation in the Surface Transportation Industry

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Throughout its first century as a nation, the United States allowed transportation to develop unfettered, in a freely competitive manner. However, by the late 1800s, a combination of cutthroat competition (where there was competition) and abuses of market power (where there was no competition) led to the creation of the Interstate Commerce Commission (ICC). It was the first national regulatory commission. Previously, the only attempts to regulate surface transportation commerce had been at the state level—although the railroads challenged much of this legislation. In 1877, the U.S. Supreme Court affirmed the legality of state regulation and ruled that railroads were engaged in public interest activities and therefore could charge only reasonable sums (*I*). However, state-by-state regulation was not the best solution, because railroads used the courts and differential rate bases for movements within and between states to circumvent the state commissions' orders.

REGULATION

In February 1887, the Interstate Commerce Act was signed into law by President Grover Cleveland. Among the outlawed activities were traffic pools and rate discrimination. Rates were to be “reasonable and just.” Oversight was to be accomplished by a five-person, presidentially appointed commission. Although pooling was outlawed, joint rate-making was not. Likewise, the reasonable-and-just concept was difficult to define accurately. This gray area gave the railroads leeway in determining rate structures and, after several confrontations between the commission and the Supreme Court, led to a relatively benign oversight capability.

Early changes to ICC came from the 1903 Elkins Anti-Rebating Act, which made the official transportation rate published with ICC the legal rate, and from the 1906 Hepburn Act, which gave ICC broad powers not only to review rates on complaint but also to replace a rate with one it determined was reasonable and just. The Hepburn Act should have led to greater rationalization of the transportation rate system, specifically to pricing on a cost-of-service basis. However, instead of using its new, increased powers to eliminate abuses of value-of-service pricing, ICC made the basic rate structure the effective law. Although this allowed producers of raw materials and agricultural goods to enjoy lower freight transportation rates, bringing more rapid economic development to some areas, it also penalized manufacturers. The new rates reduced national economic efficiency because

factories located far from the raw material sources but close to final markets, to minimize total transportation costs.

By 1910, industry earnings were insufficient because authorized rates had not increased during a moderately inflationary period. The industry attempted to improve profits through general rate increases. These attempts did not sit well with the U.S. Congress and led to passage of the Mann–Elkins Act in 1910, giving ICC new powers to suspend rate increases for up to 10 months while conducting an investigation. Additionally, the act gave ICC oversight of communications rates set by cable telephone and telegraph (later transferred to other agencies).

With the advent of World War I, railroad traffic began to snarl. Eastern terminals had too many full cars, while western terminals had a dearth of available cars. This prompted proposals for nationalization of the railroad industry, accomplished when President Woodrow Wilson bypassed ICC. Federal control of the railroad industry ended in March 1920 with the Esch–Cummins Transportation Act, which heightened the rate-setting power of ICC, increased the number of commissioners to 11, and created the Railroad Labor Board to settle labor disputes.

The Great Depression brought significant changes to both the railroad industry and the nature of transportation in the United States as the federal government began to subsidize the development of a national highway system. The combination of reduced economic activity and increased competition led to significant financial problems for the railroads, as both traffic levels and rates fell. The Emergency Railroad Transportation Act of 1933 allowed for the creation of a federal Transportation Coordinator to oversee the industry. This act changed the direction of rate-making oversight, instructing ICC to evaluate rates in terms of their effect on shippers. Although the Transportation Coordinator was relatively ineffective in realigning the rail industry, his reports to Congress eventually led to the passage of the Motor Carrier Act of 1935, placing the highway transportation industry under ICC oversight. One response by the railroad industry to the new federal oversight was the creation of the Association of American Railroads in 1964.

In contrast to the World War I experience, the railroads were not nationalized for World War II but coordinated by the Office of Defense Transportation. After World War II, the nature of ICC and the transport industry changed dramatically. A major change in the regulatory environment was the 1948 Reed–Bulwinkle Act, which allowed rate bureaus to set rates without the Sherman Act’s antitrust oversight but still subject to ICC approval.

DEREGULATION

By the mid-1950s, the railroad industry’s severe economic problems became apparent, but the motor carrier industry was prospering. The 1958 Transportation Act looked to improve the declining status of the rail industry while leading toward a more rational rate structure. The act allowed the railroads to eliminate much of their money-losing passenger traffic and moved much of what remained of state oversight to the ICC. This change helped the industry but still did not push it toward long-term economic viability.

The 1960 report authored by the Senate Transportation Study Group under John P. Doyle and presented to the Senate Committee on Interstate and Foreign Commerce concluded that both the railroads and the regulated motor carriers were subject to an economic disadvantage compared with the nonregulated private motor carrier industry. Regulated motor carriers were burdened with generally higher labor costs than the

nonregulated carriers because they relied on unionized labor and were subject to regulatory oversight on routes and traffic as well as rates. The report recommended that ICC base its rate regulation on cost-of-service rather than on value-of-service. Part of the effect was to increase the reliance on Rail Form A, developed in 1931, as a tool for evaluating the costs of rail service. This shift moved the concept of long-run marginal cost to the forefront of regulatory analysis.

Throughout the 1960s, ICC continued to regulate the railroads through both minimum and maximum rate cases. Also, ICC's opinion of mergers changed. During this decade, rail mergers formed the Penn-Central and the Burlington Northern railroads. Although the mergers were directed toward making the partners more efficient, ICC took the position that mergers also must consider the condition of other carriers. The ICC policy, in part, was to include bankrupt or financially weak carriers in the mergers. Although this approach theoretically might average the benefits and continue service over specific lines (merging partners had to keep all routes and interchanges open), the net effect was to weaken the economic viability of the merging partners. For example, including the New Haven Railroad in the Penn-Central merger helped lead to eventual bankruptcy. Motor carrier consolidations also were allowed, greatly reducing the number of common carriers.

Finally ICC reported that the northeast rail system could not be salvaged without congressional action. The resulting legislation was the Regional Rail Reorganization Act (3-R Act) of 1973, which merged seven bankrupt eastern railroads into the Conrail System. However, the 3-R Act did not eliminate the problems of the rail industry and was followed by the Railroad Revitalization and Regulatory Reform Act (4-R Act) in 1977. This ruling went partway toward letting the industry compete with truckers in setting rates for piggyback traffic. Nonetheless, it too did not resolve the industry's underlying problems—its inability to set rates under ICC oversight that could compete with those of the motor carrier industry; its inability to develop innovative technologies; or its inability to abandon marginal or unprofitable trackage. The 4-R Act mandated changes in the accounting and costing systems applied in evaluating rail traffic, resulting in the replacement of the old Rail Form A system with the computerized Uniform Rail Costing System (URCS).

Although the changes allowed by the 3-R and 4-R Acts moved the rail industry toward a deregulated environment, they were not sufficient to move the industry toward normal profitability in an era of deregulation and competition. Congress responded by passing the Staggers Rail Act of 1980, removing many of the remaining restrictions on rail activity. More rapid-abandonment procedures were instituted, and the companies were given greater flexibility over pricing. Prices were assumed to be reasonable unless the railroad was proved to be market dominant over the traffic. Interestingly, this strategy tended to move the industry back toward value-of-service pricing and away from the cost-of-service pricing that had been ICC's goal during the previous few decades.

The motor carrier industry had been as restricted as the railroads. Under the Motor Carrier Act of 1935, ICC was given control over rates charged, entry and exit, and routes of service. Although oversight differed for common carriers and contract carriers as well as for some unregulated sections of the industry, by the mid-1970s it was apparent that changes were necessary to increase economic efficiency. ICC allowed some opening of the industry to competition in 1977 and 1978 by expanding the entry standards and allowing private (and unregulated) carriers to solicit freight on a for-hire basis. The major change for the industry came with the Motor Carrier Act of 1980, which did not completely deregulate

the industry but opened it to greater competitive forces. This act greatly eased entry to the industry. The number of carriers increased from 18,000 in 1980 to almost 50,000 today. Most of the entry into the industry was in the area of truckload traffic rather than in the less-than-truckload (LTL) area, which remained relatively stable in terms of the number of firms. Much of the stability in LTL is due to the warehousing function of the sector. Just as important as the entry-and-exit easing was the carriers' increased ability to take independent rate action rather than going through rate bureaus.

With the effective deregulation of both the railroads and the motor carriers came significant improvements in productivity as well as reductions in transportation rates. Railroads were allowed to price on the basis of the value of and the demand for their services and to carry the traffic that was most profitable. Increased flexibility in pricing increased revenue and investment. The railroads reinvested much of the improved revenue stream into their infrastructure. Productivity increased dramatically, but profits did not. Martland indicates that between 1965 and 1995, using an output index, freight increased from 96 to 147 (with 100 in 1978) and revenue per ton-mile increased from \$1.27 to \$2.40, but an index of costs over the same period increased from 62 to 433 (2). Rail profitability was squeezed between increasing costs and revenues per unit of output, which were increasing at a much slower rate than costs.

Most of the rate reductions relative to cost increases have accrued unevenly to shippers. Many shippers have accused the railroads of using market power to extract rates that are not justified by the cost of service. Under current standards, however, the shipper must prove that a firm is market dominant before challenging a rate. Although rates remain regulated in theory, in practice the threshold for proving market dominance has reduced the instances in which shippers have been successful in challenging rates.

In the mid-1980s, analysts began to question the need for a separate regulatory body to oversee a transportation industry that was shrinking in terms of the number of firms (railroads) yet fairly competitive in the other sector (motor carriers). After more than 100 years of regulating surface freight and passenger transportation, ICC was replaced by the Surface Transportation Board (STB) under the U.S. Department of Transportation. Although STB continues to have oversight of economic conditions in both segments of surface freight transportation, the duties and funding have been reduced from earlier ICC days.

With the removal of ICC control, motor carriers and railroads were effectively deregulated from an economic standpoint in terms of rates and routes of service. Regulation continues, however, in the areas of safety and operations. The railroads are overseen by the Federal Railroad Administration (U.S. Department of Transportation), and the safety factors of the motor carrier industry are overseen by both the U.S. Federal Highway Administration and state transportation departments. In addition to safety regulations, the highway segment is subject to operating hour and weight restrictions.

REREGULATION?

The question that will face the surface freight transportation industry in the 21st century is whether the current deregulated environment is appropriate or whether a return to some additional oversight is necessary. The answer depends on which segment of the industry is being viewed and who is analyzing the industry.

For the motor carrier sector, the future of regulation appears to be primarily in the area of safety and size regulation. One primary difference between the motor carrier industry and the railroads is the ease of entry and exit from the industry. As a startup, a motor carrier firm requires minimal capital, whereas a railroad requires not only significant capital but also a high level of infrastructure development. In many ways, the motor carrier industry resembles the economic model of a perfectly competitive industry in which competition, market entries and exits, and a generally homogeneous product work together to force rates toward the minimum, long-run average variable cost. Firms that are able to produce most efficiently survive, but the less efficient do not. An important side effect of the relatively competitive motor carrier industry is that when traffic is competitive with the railroads, the motor carrier rates act as a constraint on rail rates. As long as these industry characteristics are maintained, forces to reregulate the economic side of the motor carrier industry probably will not prevail.

The railroad industry might face a somewhat different future. Partially as a result of deregulation allowing rail mergers with less regulatory oversight, the industry has shrunk to four primary (and several lesser) Class I carriers. With only two primary carriers in the east and two in the west, debate over the appropriateness of reregulation is ongoing. Martland has argued that the industry should consider the possibility of supporting reregulation as a means of increasing profitability (3). Many shippers argue that the reduction in the number of potential carriers, especially for bulk commodities, has led to abuses of market power when there is only one dominant carrier.

This argument eventually will lead to the subject of competitive access. This could take the form of access by one railroad over the trackage of another railroad in an effort to create competition between carriers where it otherwise might not exist. More likely, it might mean a return to one carrier having mandatory interchange rights to industry on another carrier's trackage. The industry has opposed forced competitive access when it was imposed but also has used it to meet regulatory oversight requirements by STB.

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