

Subcommittee on Railroads
Hearing on
The Status of Railroad Economic Regulation

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PURPOSE

This hearing will examine the current state of regulatory standards for the remaining economic regulation of rail carriers. That responsibility resides in the Surface Transportation Board (STB).

BACKGROUND

Federal economic regulation of rail carriers began in the United States with the Interstate Commerce Act of 1887. The Interstate Commerce Commission, the first independent federal regulatory agency, was assigned responsibility for administering this regulatory regime. The scope of regulation was gradually expanded beyond railroad rates and practices by subsequent legislation to cover line construction, mergers, carrier practices, and line abandonments. Until the Department of Transportation was created in 1966, the ICC also administered all federal rail safety requirements. In 1935, motor carriers (truck and bus service) were placed under the ICC for economic and safety regulatory purposes. The ICC's trucking responsibilities were substantially reduced by deregulation in 1980, and were virtually eliminated in the 1990s.

The pre-1980 rail regulatory regime virtually precluded flexible market entry and exit and market-responsive adjustments, and when combined with the rise of air and motor carrier transportation as alternatives to rail passenger and freight service, brought the railroad industry to the brink of bankruptcy. In the period from the late 1950s to the early 1980s, a number of major railroads actually went bankrupt.

The principal legislative response to these developments was the Staggers Rail Act of 1980, which substantially deregulated rail carriers. It is generally acknowledged that this brought about a major turnaround in the financial condition of the industry. No major rail carrier has failed since the early 1980s.

In the ICC Termination Act of 1995 (ICCTA), Congress replaced the 5-member Interstate Commerce Commission with a smaller 3-member Surface Transportation Board. Currently, the STB is chaired by Roger Nober, a Republican appointed by President Bush, with a term expiring at the end of 2005. The statutory terms of the STB's other two presently vacant seats end on December 31 of 2007 and 2008, respectively.

Under ICCTA, the STB remained independent for decision-making purposes, but became

administratively affiliated with the Department of Transportation. The ICCTA also further reduced the scope of the agency's regulatory responsibilities by eliminating a number of outdated requirements and by transferring most of the ICC's minor motor carrier responsibilities to DOT. The ICCTA also replaced the original permanent (non-expiring) authorization of the ICC with a time-limited, 3-year authorization for the STB. That authorization expired at the end of FY 1998. The Subcommittee held a hearing on the STB's resources and requirements in the spring of 2003.

Regulatory Standards: Inter-Carrier Transactions, Line Construction, and Abandonments

The broad policy issue is whether the regulatory standards in this area, established by the Staggers Act and revised by the ICC Termination Act of 1995, have functioned as intended, and whether any problems that may have manifested themselves since 1995 might be addressed in STB reauthorization legislation.

The following is a summary of the types of inter-carrier transactions, plus construction and abandonment matters, that fall within the jurisdiction of the STB. In general, the STB has the administrative power to "exempt" most rail matters—other than labor protection requirements-- within its jurisdiction from the full regulatory process otherwise applicable [49 U.S.C. 10502], if certain conditions are met. As to matters of railroad industry infrastructure, the exemption power is most frequently employed with respect to abandonments and line sales.

Besides the standards and procedures described below, the STB's statute grants the federal agency exclusive jurisdiction over railroad "rules (including car service, interchange and other operating rules), practices, routes, services, and facilities" [49 U.S. C. 10501(b)].

1. Mergers and Acquisitions of Control

Mergers and acquisitions, particularly among major Class I railroads, have been the focus of policy debate in this area. Since the 1920s, the statutory standard for approving such mergers has been a "public interest" test, under which the agency must evaluate the benefits and detriments of a proposed transaction, including the likely effect on competition, before approving or disapproving the transaction. Since the enactment of the ICC Termination Act of 1995, separate statutory standards have applied to transactions involving Class I railroads [49 U.S.C. 11323(a)-(c)] and those involving only smaller Class II and Class III carriers [49 U.S.C. 11323(d)].

The STB has broad authority to attach "conditions" to any approval of a merger or acquisition to address competitive and other policy issues. It must also apply specific statutory conditions for the income protection of employees adversely affected by the transaction. In the case of transactions involving Class I carriers, this means the ICC's New York Dock standard of one year of salary and benefit protection for each year of prior service, up to a maximum of 6 years [49 U.S.C. 11326(a)]. For transactions involving a combination of Class II and Class III carriers, mandatory labor protection arrangements for adversely affected employees may not exceed one year of pay, calculated on the basis of the previous year's earnings; for transactions involving only Class III carriers, no labor protection may be required [49 U.S.C. 11326(b)].

Once approved by the STB, a merger or acquisition is exempt from all other law, including antitrust exposure, to the extent needed to carry out the transaction. This also applies, on a case-by-case basis, to specific provisions of pre-existing labor contracts. If a dispute arises between labor and management on such displacement, the matter is resolved by arbitration, with appellate review by the STB. However, this STB-supervised arbitration procedure (known as "cram-down") is far less frequently employed

today, due to a labor-management agreement on the subject reached several years ago.

2. Trackage Rights Arrangements

Inter-carrier transactions also encompass arrangements such as trackage rights agreements. These are contractual relationships in which one railroad is permitted to use another's tracks or facilities for compensation. These arrangements are most often created as the result of a "condition" imposed as part of a merger approval decision, in order to mitigate potential anti-competitive effects of the merger.

4. Pooling Agreements

Carriers may also form equipment pooling arrangements, in effect, consortiums to allow the shared purchase of a large number of interchangeable cars [49 U.S.C. 11322]. These arrangements, once approved, enjoy immunity from antitrust challenge.

5. Interchange and Routing Obligations

Railroads also must deal with each other on matters such as routing and interchange of traffic that must traverse more than one railroad to reach its destination. The STB has the statutory authority to require or "prescribe" such inter-carrier arrangements if they cannot be established on a voluntary basis [49 U.S.C. 10703, 10722].

6. Construction

Construction of a new line requires STB approval, applying the standard that such construction is "not inconsistent" with the public convenience and necessity [49 U.S.C. 10901]. One policy issue raised in past Subcommittee hearings is the uniformity of this standard (including associated environmental impact analysis), whether the "construction" in question is the actual creation of a new rail line, or just the reactivation of a line that has been out of service or subject to an "interim" use such as "railbanking." The best known current exercise of the STB's line construction jurisdiction is the pending effort of the Dakota, Minnesota & Eastern Railroad to construct a new third rail line into the Powder River Basin coal fields.

A type of regulated construction with competitive implications is a "crossing" arrangement, which the STB may order in situations where one railroad's right-of-way physically blocks the access of another railroad to a particular shipper or destination; in the absence of voluntary arrangements, the STB may order such access under specified conditions, and may set the level of compensation paid by one carrier to the other [49 U.S.C. 10901(d)].

7. Abandonments

Abandonment—the removal of a rail line from the national rail network and the elimination of the railroad's common carrier obligation to provide service over the line—requires STB approval; the applicable standard is whether the present or future public convenience and necessity "requires or permits" such abandonment [49 U.S.C. 10903]. As with major inter-carrier transactions like mergers and acquisitions, the STB is required by law to mandate "labor protection" arrangements for adversely affected employees, based on standards that closely parallel the 6-year New York Dock standard for mergers [49 U.S.C. 10903(b)].

Closely related to the abandonment process is the procedure for other public uses of the right-of-way.

Under the STB's own statute, the agency may set conditions for public use of the right-of-way and allow up to 180 days after abandonment for possible public acquisition of the land [49 U.S.C. 10905]. Under the "Rails-to-Trails" Act [16 U.S.C. 1247(d)], the STB is required to approve "interim" use of the right-of-way for trail purposes if certain specified conditions are met. Approval of such interim use, by federal law, indefinitely "postpones" the operation of pre-existing reversionary property rights by adjacent landowners, rights that would otherwise entitle them to the return of the land. This result has been successfully challenged in federal constitutional litigation by landowners as entitling the owners to federal compensation for the value of the reversionary property taken without prior compensation, with the result that issuance of each new "interim" use approval by the STB creates a liability for the federal Treasury where reversionary property interests are involved in the railroad's title to the right of way. However, the affected property owner is not paid in advance, but must bring suit in the Court of Claims for the value of the reversionary interest.

8. Line Sales

Most of the several hundred smaller Class II and Class III railroads now in existence were created after the Staggers Act through "line sales" that avoided the complete abandonment of lines considered financially marginal by the major Class I carriers. Such sales require STB approval, either where the purchaser is a company not already operating a railroad [49 U.S.C. 10901] or where the buyer is a Class II or Class III railroad [49 U.S.C. 10902]. (A purchase by a Class I railroad from another such railroad is governed by the inter-carrier standards applicable to mergers and acquisitions, discussed above.) For line sales to non-carriers, and for line sales to Class III carriers, no labor protection is required for affected employees [49 U.S.C. 10901, 10902(d)]. For such sales to Class II carriers, severance arrangements equivalent to one year of pay are required [49 U.S.C. 10902(d)].

Regulatory Standards Governing Rates and Access

The broad policy issue posed by the hearing is whether the regulatory standards in this area, established by the Staggers Act and revised by the ICC Termination Act of 1995, have functioned as intended, and whether any problems that may have manifested themselves since 1995 might be addressed in STB reauthorization legislation.

The following is a summary of the regulatory standards within the present jurisdiction of the STB governing freight railroad rates (common carrier and contract), as well as access by one rail carrier across or over the tracks of another carrier. Generally, the STB also has the administrative power to "exempt" most rail matters (other than labor protection requirements) from the full regulatory process that is otherwise applicable, if certain conditions are met [49 U.S.C. 10502]. As applicable to rate and access matters, the exemption power has been applied most frequently to exempt certain classes of rail traffic (usually those with strong competition, such as intermodal traffic).

I. RATES

1. Common Carrier Rates and Contract Rates

The Staggers Act specifically authorized for the first time the use of "contract rates"—negotiated individual rate and service agreements between rail carriers and shippers. With certain exceptions relating to possible impairment of the carriers' ability to provide common carrier service and to transportation of agricultural commodities, such contracts are confidential and are generally beyond the regulatory jurisdiction of the STB [49 U.S.C. 10709]. Entering into a transportation contract with any shipper is entirely optional on the carrier's part, unlike its mandatory obligation to provide common

carrier transportation on request. Rail transportation provided under such contracts generally is fully subject to the antitrust laws, with disputes handled as any other private-sector commercial dispute would be. (Common carrier rates, on the other hand, are generally protected from antitrust challenge by the “filed rate doctrine.”) The shipper and carrier may also establish liability arrangements that are not subject to the usual “Carmack Amendment” [49 U.S.C. 11706] standards for common-carrier liability. An estimated 60 per cent of all U.S. rail traffic now moves under contract rather than common-carrier rates.

Common carrier rates are premised on the legal “common carrier obligation” of a rail carrier to provide service to all comers on request, and thus to quote rates and services upon request [49 U.S.C. 11101]. Prior to the ICCTA of 1995, common carrier rates had to be filed in tariff form with the ICC; now, although the obligation to quote and make such rates available remains, the dissemination and availability of rates to shippers may be accomplished by other means, including electronic transmission [49 U.S.C. 11101(b)]. Generally, affected shippers are entitled to 20 days notice of any proposed increase in previously quoted rates [49 U.S.C. 11101(c)].

2. Rate-Reasonableness Standards for Common-Carrier Rates

a. “Market Dominance”

To help assure an adequate flow of revenue to rail carriers, the Staggers Act limited regulatory jurisdiction to evaluate whether rail rates are “reasonable” to rates collected in situations where the rail carrier is “market dominant” [49 U.S.C. 10701(d)]. This is defined by statute to mean situations where there is an “absence of effective competition from other rail carriers or modes of transportation” [49 U.S.C. 10707(a)]. Unless the STB finds that market dominance exists, a challenge to a rate as unreasonably high may not proceed.

Administrative interpretations by the ICC and STB have included within the market-dominance/effective-competition analysis consideration of transportation competition (intramodal and intermodal), as well as “product” competition (alternative sources for the same or substitute goods in the end market) and “geographic” competition (end-market competition from other geographic locations). In an administrative decision approximately 2 years ago, the STB generally removed product and geographic competition as factors in its market-dominance/effective-competition analysis. That decision was recently upheld on judicial review.

b. The 180% of Variable Cost “Floor”

A rate that produces revenues of less than 180 per cent of variable costs of the railroad is conclusively presumed to be non-market-dominant and therefore beyond the agency’s rate-reasonableness jurisdiction [49 U.S.C. 10701(d)]. (Railroads have very high fixed costs that do not vary with the level of service provided; therefore a rate that is 180 per cent of variable costs may not actually cover the full cost of providing transportation under the challenged rate.)

c. Evaluation of Rates

If the rate being challenged is within the STB’s regulatory jurisdiction under the standards outlined above, the STB is to evaluate the reasonableness of the rate, and must consider whether the railroad is also providing service under rates so low as to not contribute to the carrier’s going-concern value, whether the railroad is also providing service under rates that only marginally contribute to fixed costs, and whether the carrier’s mix of traffic is forcing one type of traffic to provide an unreasonable share of

the carrier's revenues--all in the context of the Staggers Act policy that all rail carriers should earn "adequate revenues" [49 U.S.C. 10701(d)(2)]. That policy is discussed below.

Administrative interpretations and rules of the ICC and STB have included the use of highly complex so-called "constrained market pricing" and "stand-alone cost" models for evaluating whether a specific rail rate is unreasonably high. The ICCTA of 1995 required the STB to complete a rulemaking by the end of 1997 to establish simplified rate-reasonableness standards for evaluating non-coal rate cases where a full stand-alone-cost presentation is too costly [49 U.S.C. 10701(d)(3)].

Another area of controversial precedent is the so-called "bottleneck" issue. Current ICC/STB administrative decisions require that a challenge to the reasonableness of a common carrier rate be made to the entire rate, i.e., the complaining shipper may not "segment" the rate into component parts for purposes of proving that a particular component exceeds a reasonable maximum. There have been some shipper complaints that this in practice allows a railroad to foreclose use of alternative rail routings, because the incumbent carrier can dramatically increase the part of the rate covering a "short haul" to a connection with a second railroad, and instead merely quote one through rate for the entire journey.

By administrative decision, the STB slightly expanded the rate-quoting obligation of a carrier that provides the single rail connection on the "bottleneck" segment of a through route that otherwise involves a choice of 2 rail carriers. The STB has ruled that the bottleneck-controlling carrier must in fact segment and separately quote a rate for the bottleneck (short-haul) segment alone, but only if the second railroad isolated from the shipper by the bottleneck segment has in fact already entered into a rate contract with the shipper for service on the non-bottleneck segment of the route. This compromise between the views of rail carrier and shippers is lifted almost entirely from a Canadian rail statute, and anomalously makes the scope of a bottleneck carrier's common carrier rate-quoting obligations depend entirely on what another carrier does in the entirely "extracurricular" area of contract transportation. However, thus far, the STB's bottleneck position has survived judicial review.

There are pending House and Senate legislative proposals that would legislatively overrule the current STB decisions and require segmented quoting of common carrier rates on both the short-haul "bottleneck" portion and the long-haul portion of a route. These include H.R. 2192 (introduced by Mr. Oberstar) and H.R. 2924 (introduced by Mr. Baker). H.R. 2924 would also shift the burden of proof that a rate is unreasonably high from the shipper to the rail carrier in areas found by the Board to be characterized by inadequate rail competition.

d. "Revenue Adequacy" of Rail Carriers

The Staggers Act required the ICC to establish standards and procedures to evaluate whether a specific rail carrier is earning revenues adequate to cover total operating costs plus a reasonable return or profit, and to attract sufficient capital to maintain a sound rail transportation system [49 U.S.C. 10704(a)(2)]. The STB conducts an annual evaluation of whether major (Class I) rail carriers are "revenue-adequate"; in most recent years, most major rail carriers have not met this standard, as determined by the STB.

Most outside analysts consider the railroads' current capital inflow insufficient for replacement and, where appropriate, expansion of its infrastructure. Since the deregulation process began in 1980, major carriers reduced their capital burdens by shedding underperforming infrastructure—around one-half of the pre-1980 network. Recently, however, with the continued growth of rail freight traffic, carriers are finding that expansion of infrastructure is necessary on key heavily used trunk lines.

e. Remedies for Unreasonable Rates

The STB may not challenge a rail carrier's common-carrier rate on its own motion, but only on complaint from an outside party [49 U.S.C. 10704(b)]. If the agency determines, using the standards outlined above, that the rate in question is unreasonable, the agency may "prescribe" a reasonable rate, which the carrier may not exceed [49 U.S.C. 10704(a)]. If the shipper has already paid for transportation under the challenged rate, the shipper may recover "reparations" from the carrier for the overpayment.

3. "Unreasonable Discrimination"

Generally, the Staggers Act prohibits such discrimination among common-carrier shippers—i.e., charging different compensation from one shipper than from another "for performing a like and contemporaneous service in the transportation of a like kind of traffic under substantially similar circumstances" [49 U.S.C. 10741(a)]. The STB's powers to remedy violations with respect to unreasonable "rates, classifications, rules, and practices" also allows prescription of a replacement rate or practice in these circumstances [49 U.S.C. 10704(a)].

4. Collective Ratemaking

The Staggers Act greatly reduced the permissible scope of collective ratemaking through "rate bureaus," which were immunized from the antitrust laws with respect to such activity. Although the statute still permits collective activity under tightly circumscribed conditions [49 U.S.C. 10706], such bureaus are of little current commercial significance. Instead, carriers price their common-carrier services on a single-railroad basis and in the increasingly used contract-rate arena, on an entirely individualized basis.

II. ACCESS

1. Terminal Area Access

The STB's authority includes the power to require one railroad to make its terminal facilities (including main-line track for a "reasonable distance" beyond the terminal area) available to another carrier, if such availability is "practicable," in the "public interest," and will not "substantially impair" the owning carrier's use of the facilities for its own traffic [49 U.S.C. 11102(a)]. The Board also may set compensation and other terms and conditions for such access. Although the ICCTA generally removed passenger rail operations from the STB's regulatory jurisdiction, it did preserve the power of publicly owned commuter authorities to utilize the compulsory terminal access remedies in Section 11102.

2. Reciprocal Switching and Switch Connections

Reciprocal switching arrangements allow one railroad to provide service over another's tracks to reach a particular shipper location. The statute also empowers the STB to require rail carriers to enter into such arrangements, either because they are "practicable" and in the "public interest," or because such action is "necessary to provide competitive rail service" [49 U.S.C. 11102(c)]. In the absence of mutual agreement between the carriers on compensation and conditions, the STB may determine those parameters itself. Administrative precedents of the ICC have largely limited use of this power to local situations, not long-haul traffic.

Switch connections may be ordered by the STB to be constructed and operated in order to provide access to a railroad's main-line tracks from a "lateral branch line" or from a private siding [49 U.S.C. 11103]. To require such action, the STB must find that the new connection will be safe, practicable, and will provide sufficient business to justify the cost of construction and maintenance. The agency may also set compensation levels on complaint from one of the parties. Administratively, the STB has further

limited the availability of this remedy by showing a prior record of anticompetitive conduct by the incumbent railroad.

3. Crossings

Although governed by the STB's line-construction provision [49 U.S.C. 10901], the creation of crossings at which one railroad traverses another's right-of-way to reach a specific origin or destination is also a form of access with competitive implications. The agency is authorized to order such crossings to be built over the objection of the blocking railroad if neither the construction or operation of the crossing materially interferes with the operation of the crossed line and if compensation is paid; the agency may set the compensation level in the absence of voluntary agreement between the carriers [49 U.S.C. 10901(d)].

4. Trackage Rights

These arrangements allow use of one railroad's line-haul tracks by another railroad. Generally, the STB cannot require that such arrangements be entered into—except as a “condition” of a merger or control transaction that is subject to the merger approval process discussed at the May 6 hearing. [See 49 U.S.C. 11321-11323.] When two carriers voluntarily enter into an agreement for trackage rights or joint ownership, that transaction must be approved by the STB under the “public interest” standard applicable to mergers and acquisitions [49 U.S.C. 11323(a)(6)].

5. Divestiture of Lines

Current law allows the STB to mandate divestiture of particular rail lines for competitive reasons only in the context of “conditions” on approval of a merger or acquisition. [See 49 U.S.C. 11323(c).] In merger cases, the agency also retains continuing jurisdiction to modify any of the original conditions of the merger.

6. Emergency Service Orders

This power was most recently employed by the STB to deal with the 1997 traffic congestion on the Union Pacific-Southern Pacific system; the STB required UP to grant access to Burlington Northern Santa Fe and other carriers pursuant to the emergency order, and ordered frequent reporting by UP of the degree of traffic congestion. The purpose of the statutory authority is to allow the agency to address emergencies caused by shortage of equipment, congestion of traffic, an unauthorized cessation of rail service, or other traffic movement failure [49 U.S.C. 11123]. The powers of the agency to require one railroad to operate on another's lines are limited to a maximum duration of 270 days. The STB may set compensation levels in the absence of voluntary agreement, but a carrier ordered to operate on another's lines must derive its compensation solely from revenues from those operations. (This power originated as a Congressional response—the Esch Car Service Act of 1917—to massive rail congestion on the east coast resulting from offshore U-boat attacks on coastal shipping.)

The STB's emergency powers under Section 11123 were recently expanded by the FY04 omnibus appropriations measure: the STB is now also empowered to maintain directed emergency service for freight and commuter transportation affected by any cessation of operations by Amtrak. This form of emergency service does not have to be self-funded, and the STB was granted a contingency appropriation of \$60 million for FY04 as an emergency service fund.

In addition to powers to deal with transportation emergencies as outlined above, the STB is also

authorized to give traffic priority to troops, war material, and other essential government traffic in time of war or threatened war [49 U.S.C. 11124].

WITNESSES

PANEL I

[Hon. Roger Nober](#)
Chairman
Surface Transportation Board

PANEL II

[Mr. Edward Hamberger](#)
President
Association of American Railroads

[Mr. Richard Timmons](#)
President
American Short Line & Regional Railroad Association

PANEL III

[Mr. Terry Huval](#)
Director of Utilities
City of Lafayette, Louisiana

[Mr. Charles E. Platz](#)
President
Basell North America Inc.

[Mr. Steven D. Strege](#)
Executive Vice President
North Dakota Grain Dealers Assn.

[Mr. John Ficker](#)
President
National Industrial Transportation League

[Mr. William J. Rennie](#)
Managing Director
Mercer Management Consulting, Inc.

Dr. Curtis Grimm
Professor of Transportation & Logistics
University of Maryland