

Public Interest Comment¹ on
The Surface Transportation Board's Notices of Proposed Rulemaking:
Docket No. EP 761, Railroad Revenue Adequacy
Docket No. 722, Railroad Revenue Adequacy

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Introduction

The authors of this public interest comment were the members of a committee of experts in economics, regulatory policy, and freight transportation convened in 2014 by the National Research Council (NRC) of the National Academy of Sciences and instructed, in response to a Congressional mandate,⁹ to address and make recommendations on the regulation of railroad rates by the Surface Transportation Board (STB) as well as on a number of related issues. In our work we were supported by staff of the NRC's Transportation Research Board. We convened five times as a group, had numerous conference calls and email exchanges, and were briefed by representatives from the railroad industry, shipper groups, and government agencies, as well as academic and consulting organizations. Our 264-page report, entitled *Modernizing Freight Rail Regulation* (MFRR),¹⁰ was published in 2015.

¹ This comment reflects the views of its authors, not the views of any institutions with which they are affiliated or the National Research Council. Affiliations are provided for identification purposes only. None of the authors have been compensated in any way for participation in writing or submitting this comment.

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⁹ Public Law 109-59, Section 9007.

¹⁰ National Academies of Sciences, Engineering, and Medicine 2015. *Modernizing Freight Rail Regulation*. Washington, DC: The National Academies Press. <https://doi.org/10.17226/21759>.

We are submitting this brief comment in Docket Nos. EP 722 and 761, Railroad Revenue Adequacy, because several recommendations in our MFRR report are directly relevant to this proceeding. One aspect of the STB's Rate Reform Task Force (RRTF) proposal – calculation of revenue adequacy over a multi-year period – is clearly more consistent with the approach recommended in MFRR (8, 214-15) than the current practice of assessing revenue adequacy on an annual basis. Nevertheless, we are concerned that the proposal describes a mechanical process with no scope for the STB to study the economics of the industry and exercise judgement. We have deep reservations about the rate increase cap proposal in the RRTF report. The proposal would establish rate increase caps based on the relationship of a shipper's rates to a benchmark calculated using costs derived from the inherently arbitrary Uniform Rail Costing System (URCS) and arbitrary allocations of profits that exceed the cost of capital.

Time frame for calculating revenue adequacy

The MFRR report expressed skepticism about the usefulness of the STB's statutorily required annual revenue adequacy determination, while noting that "policy makers need to be able to determine whether a railroad's profits consistently fall outside a reasonable band of profitability for a prolonged period" (MFRR, 175). The RRTF report similarly notes that "a single-year snapshot might be an outlier and indicate a misleading conclusion" and states that the annual revenue adequacy determination under EP 552 does not measure long-term revenue adequacy (RRTF, 33). The RRTF report proposes to measure long-term revenue adequacy over the length of the business cycle, including a year in which a recession begins and a year after the year in which a recession begins, with a minimum time span of five years. This proposal is more consistent with the MFRR's recommendation that the STB examine railroad profitability over a longer period (8, 214-15). We caution, however, that even competitive industries may have cycles of high and low profits that may last longer than five years and do not necessarily correspond to the business cycle. Therefore, the STB should consider carefully whether the business cycle or some other time period is most relevant for accurately assessing long-term revenue adequacy.

Arbitrary allocation of common costs and profits

The RRTF report proposes to cap increases in tariffed rates (but not exempt or contract rates) for carriers that are long-term revenue adequate. The STB would calculate a "rate increase constraint" for different categories of shipments by attributing a portion of the railroad's profits that exceed the cost of capital to each category based on that category's share of revenues with R/VC ratios exceeding 180 percent. The STB would calculate the R/VC ratio for each category that would eliminate those excess profits, and the rate that produces that R/VC ratio would be the rate increase constraint for that category. If a shipper complains, a rate would not be permitted to rise any further than the rate of inflation if the railroad is long-term revenue adequate (RRTF, 36-37).

We are deeply concerned that this approach creates a rate increase constraint that is divorced both from economic reality and from a well-articulated goal that the proposal is designed to achieve.

First, as MFRR documents in detail, URCS-based variable cost figures are inherently inaccurate and unreliable. A large percentage of the costs a railroad incurs cannot be directly attributed to individual units of traffic. “Division of these cost items in any economically meaningful way among individual units or narrow segments of traffic is simply not possible.” (MFRR 109) This problem is fundamental and cannot be solved by procedural or mechanical changes: “No cost allocation scheme can yield economically valid relationships for assessing a railroad’s rate levels or market power” (MFRR 107). This insoluble problem is not a surprise to analysts familiar with the economics of public utilities and network industries. Therefore, using URCS-based R/VC ratios to calculate rate increase constraints is likely to introduce significant errors, capping increases in rates that may be reasonable and permitting increases in rates that may be unreasonable.

Second, the RRTF proposal adds another layer of arbitrary calculations by allocating profits that exceed the cost of capital to each category of shipments based on that category’s share of revenues with R/VC ratios exceeding 180 percent. Such an allocation has no rational basis in economics.

Precedent for more extensive rate of return regulation

Even if this problem with cost and profit allocations could be overcome, we remain skeptical about the wisdom of calculating ex ante rate caps for classes of traffic based on railroad revenue adequacy estimates. This proposal could move STB rate regulation in the direction of public utility regulation rather than the protection of captive shippers. We warned in MFRR:

Such an application could result in the evolution of STB’s industry-wide cost of capital figure into something resembling public utility rate-of-return regulation in which the firm is constrained to pricing levels yielding a return on capital that is no higher than a prescribed level. Rate-of-return regulation has had a mixed record in the industries in which it is used because it can incentivize excessive capital-to-labor ratios and lessen the motivation for asset replacement and the pursuit of innovation. Rate-of-return regulation connotes an interest in restricting railroad profitability that would be at odds with the deregulatory thrust of the Staggers Act reforms. (MFRR, 155-56)

We appreciate the fact that in the RRTF report, STB staff sought to devise a constraint that would apply only to rate increases that exceed the rate of inflation for tariffed rates on shipments that already appear, based on inherently unreliable URCS-derived cost estimates, to be making large contributions to railroads’ common costs. We are concerned that what is expressed as a limit on rate increases may turn out to be limits on rates on different classes of commodities that have no basis in economics. The proposal will also have the effect of differentially

regulating different railroads based on the strength of their income statements. A full consideration of the effects of subjecting different railroads to different regulations based on their financial strength should be undertaken if this proposal is to go forward. For example, while we favor removal of bottleneck protection (aka reciprocal switching) as a potential remedy in rate cases (MFRR, 204-5), we do not understand the advantage of having different reciprocal switching rules for different railroads based on their relative financial strength.

Alternatives

We believe the STB should retain its focus on the protection of captive shippers and resist the temptation to impose blanket caps of any sort on categories of rates. The STB itself has suggested a more efficient approach to protecting captive shippers in Docket No. EP 755, Final Offer Rate Review, and Docket No. EP 756, Market Dominance Streamlined Approach. As we stated in our comments in those dockets, we see no reason that the final offer process could not be expanded to apply to larger shipments, rather than just the smallest shipments, perhaps with different standards for revenue-adequate railroads. The rate benchmarking approach recommended in our MFRR report (MFRR, Ch. 3 and Appendix B) could be used as another criterion for determining whether a railroad is market dominant.¹¹

A more comprehensive solution to rate regulation reform could be achieved if, following our recommendations in MFRR (Chapter 5) the STB recommended to Congress that it be given statutory authority to require final-offer arbitration for rate disputes and to employ rate benchmarking instead of the URCS-based R/VC ratio to assess market dominance. Those approaches could provide a lower-cost and more expeditious way of protecting all captive shippers without putting the STB in the position of imposing what appears to be a form of public utility regulation in the transport sector.

¹¹ See also Wesley W. Wilson and Frank A. Wolak, “Benchmark Regulation of Multiproduct Firms: An Application to the Rail Industry,” National Bureau of Economic Research Working Paper No. 25268 (2018).