The Heritage Foundation Issue Bulletin

No. 129 | The Heritage Foundation • 214 Massachusetts Avenue • N.E. • Washington, D.C. • (202) 546-4400

June 5, 1987

THE CONSUMER RAIL EQUITY ACT: RETURNING TO THE DARK DAYS OF REGULATION

I am convinced that we would have had no Conrail to sell today without the Staggers Rail Act of 1980...the nation's rail system remains a private-sector industry only because of [Staggers].

L. Stanley Crane
Chairman,
Consolidated Rail Corporation (Conrail)[1]

INTRODUCTION

In the United States' largest-ever stock offering, the federal government this March sold its 85 percent interest in the Consolidated Rail Corporation, popularly known as Conrail, for approximately $1.6 billion. This put the freight railroad back into private hands after ten years under Washington's control. Yet only a few years ago, it was assumed widely that Conrail would be a permanent ward of Congress. Not only was Conrail losing hundreds of millions of dollars each year, but most of the nation's other railroads also teetered on collapse. Rather than discussing the privatization of Conrail, most lawmakers were speaking of the prospect of nationalizing the rest of the railroad system.

This dismal situation began to change in 1980 with the Staggers Rail Act, which partially deregulated the railroads.[2] The Act, among other things, allowed the railroads greater rate flexibility and eliminated regulation altogether for most traffic. In the seven years under Staggers, the railway industry and its customers have seen a remarkable improvement. Rates to railroad customers have dropped, and service has improved tremendously with total savings to consumers estimated at as much as $20 billion dollars annually.[3] And the railroads have returned to financial health, although their earnings are still relatively low.

Threatening the Gains of Consumers. Not all shippers, admittedly, are happy with this transformation. Many of those who are dependent upon rail transportation to get their

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1. Letter from L. Stanley Crane to Senator Alphonse D'Amato (R-NY) dated January 7, 1987.

2. Named in honor of retiring House Foreign and Interstate Commerce Committee chairman Harley O. Staggers.

3. Christopher C. Barnekov, "A Look at the Two Faces of Railroad Deregulation," Traffic World, August 18, 1986.

Note: Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

goods to market--primarily shippers of coal and other bulk commodities--complain that they have not shared fully in the benefits of deregulation because of a perceived lack of competition. Ostensibly to remedy this, several bills have been introduced in Congress to roll back the Staggers Act. Chief among these is the so-called "Consumer Rail Equity Act" (S. 676 and H.R. 1393) introduced by Senator Jay Rockefeller, the West Virginia Democrat, and Representative Frank Boucher, the Virginia Democrat.

Reregulation, however, would do more harm than good. There is substantial evidence that the needs of all shippers can be met by the market in the current partially deregulated environment. Subjecting the railroad industry to increased control by the federal bureaucracy, meanwhile, would threaten seriously the gains made by rail customers and consumers in the past seven years. It would increase costs and reduce service for the majority of U.S. consumers, while possibly driving railroads back to the edge of bankruptcy.

RAIL REGULATION IN THE U.S.

Federal regulation of the railroad industry began exactly a century ago, with the creation of the Interstate Commerce Commission (ICC) in 1887. At that time, almost all long distance passenger and freight travel was by rail, and it was generally believed that railroads possessed uncontrolled monopoly power. This understandably prompted wide support for federal control of railroads.[4]

For the following 93 years, almost every aspect of the U.S. railroad industry was regulated by the ICC. The Commission approved maximum and minimum prices for each commodity and each route served by the railroads, prevented special discounts to customers, and required extensive public hearings before service on any line could be discontinued. Mergers between railroads and other transportation companies were banned.

The railroad industry continued to dominate U.S. transportation through the first third of this century when it began losing business to the trucking industry. Shippers took full advantage of their newfound alternative to railways. The railroads had accounted for 74.9 percent of the intercity freight traffic in 1929, but this share fell to 44.1 percent in 1960. By 1975, it was down to 36.7 percent.[5] Net operating income also took a nosedive, falling from over $5.7 billion in 1929 (in constant 1977 dollars) to $343 million in 1977.[6]

Edging on Collapse. By the 1970s, U.S. railroads were in abysmal shape. The return on net investment never exceeded 3 percent between 1970 and 1979, at a time when even a simple savings account was paying 5 1/2 percent.[7] Indeed, the entire industry edged on collapse. Between 1967 and 1973, the Penn Central railroad and seven other eastern railroads, representing the bulk of the northeastern railroad system, went into bankruptcy. To preserve freight service in the region, these firms were purchased by the federal

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4. More recent scholars have pointed out that railroads actually supported regulation because it created a government-enforced cartel, benefiting them at the expense of consumers. Gabriel Kolko, Railroads and Regulation, 1877-1916 (Princeton University Press, 1965).

5. Association of American Railroads, Railroad Facts, 1986, p. 32.

6. Calculated from Railroad Facts, op. cit., p. 17.

7. Railroad Facts, op. cit., p. 18.

government and reorganized into Conrail, at a cost to taxpayers of about $7.7 billion over the next decade.[8] Nevertheless, failures continued. By the late 1970s, railroads representing 21 percent of U.S. railroad mileage were operating under the control of bankruptcy courts.[9]

Shippers and consumers were hit badly by the decline of the industry. Strapped for cash, the surviving railroads no longer could maintain their systems adequately, and they began to deteriorate. By 1975, railroads were forced to reduce speed limits on 15 percent of their tracks because of track conditions.[10] On many mainline stretches where freight trains at one time generally had run at 60 mph or more, the railroads were forced to impose limits of 10 miles per hour or less.

Standing Derailment. Worse still, the rails became dangerous: the number of train accidents caused by track defects almost quadrupled between 1967 and 1971.[11] The situation became so bad that the term "standing derailment" was coined by railroad analysts to describe the increasingly frequent phenomenon of freight cars slipping off deteriorating track while stationary.

Prices paid by shippers for this deteriorating service, meanwhile, increased about 10 percent faster than the consumer price index between 1967 and 1971.[12] Not surprisingly, a 1975 Department of Transportation survey found that 34 percent of the nation's shippers did not feel they were getting adequate service, while over 97 percent of shippers found truck service to be adequate.[13]

DEREGULATION OF THE RAILROADS

Policymakers tried for several years to deal with the troubled state of the industry through more government controls and involvement. Billions of dollars were spent on guaranteed loans and direct federal aid to the industry. But by the mid-1970s, policymakers came to realize that the solution lay in less, not more, federal involvement. Lawmakers began to appreciate that the ability of railroads to compete effectively with other forms of transportation was being hampered by the pervasive controls and the red tape imposed by the ICC.

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8. See James L. Gattuso, "Giving Conrail a Green Light," Heritage Foundation Issue Bulletin No. 113, February 15, 1985.

9. Frank Wilner, Railroads and the Marketplace, March 17, 1987 (to be published in Transportation Law Journal, Fall 1987).

10. Department of Transportation, A Prospectus For Change in the Freight Railroad Industry, October 1978, p. 25.

11. Wilner, op. cit., p. 7.

12. Paul W. MacAvoy and John W. Snow, eds., Railroad Revitalization and Regulatory Reform (Washington, D.C.: American Enterprise Institute, 1977), p. 3.

13. U.S. Department of Transportation, A Prospectus For Change in the Freight Railroad Industry, October 1978, p. 19.

The first step toward loosening restrictions was the 1976 Railroad Revitalization and Regulatory Reform Act, known as the "4-R" Act. This Act was the first legislation that recognized that railroads were no longer the monopolists of a century earlier and that in most of their business they now competed fiercely with trucks and other forms of transport. The "4-R" Act freed railroad rates from ICC review, other than in cases where a railroad was found to be "market dominant," that is, where there was no adequate competition. Shippers facing such a lack of adequate competition are known as "captive shippers." The trouble was that the ICC predictably was reluctant to yield power and thus interpreted the Act narrowly, concluding that over three-quarters of railroad traffic was "captive" and therefore subject to regulation.

Staggers Rail Act. Sweeping changes in rail regulation came four years later with the Staggers Rail Act of 1980. Among the most important provisions of the legislation:

1) A railroad could not be declared "market dominant" if its rates were below a certain percentage of the "variable," or incremental, cost of the service.[14] This freed approximately 75 percent of all rail traffic from rate regulation.[15]

2) Where a railroad was market dominant, the ICC would still consider whether it was making adequate revenues overall in determining whether a particular rate was unreasonably high.

3) All rates could be raised to cover inflation, plus 6 percent, each year for four years, without ICC approval. After that, rates could be raised 4 percent each year if the railroad was not revenue adequate.

4) Shippers and railroads were permitted to bypass the entire regulatory system, if they wished, and negotiate their own rates for rail service.

Since 1980, deregulation has been augmented by an ICC, led by Reagan-appointed commissioners, which generally has favored deregulation. They have interpreted the Staggers Act broadly and have helped the industry lower costs by approving necessary mergers and divestitures of track, among other actions.

Since deregulation, the fortunes of the railroads and their customers have improved dramatically. Rate structures, which had pleased regulators but bore no relation to the actual cost of service, have been rewritten. Innovative services have grown rapidly. Example: "piggyback" service, which allows a truck-trailer to be carried directly on a railroad car, enabling railroads to compete more aggressively with trucks. While this service was available before 1980, deregulation is credited with spurring the aggressive market techniques that have made it a commonplace.

Costs have been cut by railroads shedding excess trackage. Railroads have caught up with long-deferred maintenance and repair, restoring track and equipment to sound

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14. The exact percentage would be set by the ICC at a level between 170 and 180 percent of variable cost.

15. General Accounting Office, Railroad Revenues: Analysis of Alternative Methods to Measure Revenue Adequacy, October, 1986, p. 33.

condition. And labor productivity has improved, as railroads chip away at antiquated work rules, while raising average wages.[16] In all, railway operating expenses fell in 1985 from $34.2 billion in 1980 to $25.2 billion in constant dollars, while traffic volume remained almost unchanged.[17]

RESULTS OF DEREGULATION

Lower Prices

Railroad rates have dropped substantially since Staggers was enacted in 1980. But this decline in railroad rates generally is not reflected in the standard rate indices. According to the index published by the Bureau of Labor Statistics (BLS), for example, rates have just about stayed even with inflation since 1981. Yet, had this actually been the case, rail revenues would have been about $34 billion in 1985. In fact, they were less than $27 billion.[18]

Such indices mainly reflect the "official" rates filed with the ICC. But very little traffic actually moves at those rates, as shippers routinely negotiate more favorable private contracts with railroads--a practice that was illegal before Staggers. In 1985, for instance, 63 percent of all coal, and 57 percent of all grain shipments were made under such contracts.[19] This percentage is believed to be even higher today.

Because of these problems with rate indices, the best measure of rail rates is the amount of money railroads actually receive for moving each ton of traffic. These numbers show rail costs are down. Railroad revenues per ton of freight hauled dropped over 15 percent from 1981 to 1985, adjusted for inflation, although revenues previously had been increasing each year.[20] Effective rates have fallen even lower for certain types of commodities. In 1985, farmers paid about one-third less per ton to get their products to market than they did in 1981.[21] Costs per mile have decreased even further with a 19.1 percent decrease in revenues overall per mile per ton of freight hauled, adjusted for inflation.[22]

Better Service

Railroad customers have enjoyed significantly improved service since deregulation. Staggers and subsequent ICC decisions allowing railroads to cut costs and eliminate waste yielded savings to pay for long-deferred maintenance. Railroads upgraded their equipment, ending the long period of deterioration. The result: trains once again are

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16. Railroad Facts, op. cit., p. 56.

17. Christopher Barnekov, Railroad Regulation After Five Years, December 4, 1987 (to be published in Regulation magazine), p. 14 of draft.

18. Ibid., p. 6.

19. Ibid., p. 5.

20. Derived from statistics appearing in Railroad Facts, op. cit.

21. According to ICC Quarterly Commodity Statistics.

22. Railroad Facts, op. cit., p. 30.

running at full speed and on time. The average train speed, for example, has increased 27.3 percent from 1979 to 1985, and 20.3 percent from 1980 to 1985.[23]

Further, the new power to negotiate contracts has provided new incentives for service improvement. Before deregulation, railroads were required by law to treat all customers alike, regardless of differing circumstances. Provision of special services or discounts to particular customers was prohibited. Indeed, railroads could be prosecuted by the ICC if they provided extra services for a customer, as this could be deemed an illegal discount. Railroads today routinely negotiate with their customers to provide services geared to meet particular needs of each shipment. Incentives for guaranteed damage-free service, on-time delivery, and door-to-door service are common.

Shippers recognize these improvements. According to a recent poll commissioned by the Association of American Railroads, 72 percent of rail shippers feel that since deregulation the railroads have become more dependable in keeping schedules, more responsive to customer needs, and more reliable in performance since Staggers.[24] Customer satisfaction in turn has helped the railroads by halting their decades-long slide in business. The share of intercity freight hauled by railroads stopped sliding in 1982 when it hit 35.8 percent and since has climbed to about 37 percent.[25]

Improved Safety

Railroads had to upgrade the quality of their track and equipment to win customers in the more competitive business environment. This has improved safety notably. From 1980 to 1985 the number of train accidents has been cut by 67.3 percent, decreasing from 8,451 accidents in 1980 to 2,760 in 1986. Those caused by track defects are down 70.9 percent, from 3,492 in 1980 to 1,016 in 1986.[26] A deregulated rail system has proved to be a safer one.

Improved Finances

The railroad industry is no longer on the endangered species list. Since the first tentative deregulatory steps were taken in the late 1970s, railroad return on net investment has risen substantially. While returns were about 2 percent during most of the 1970s, dropping as low as 1.2 percent in 1975,[27] by 1980 they had reached 4.2 percent.[28] Returns

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23. ICC statistics.

24. Wilner, op. cit., p. 50.

25. Railroad Facts and Thompson, op. cit. The industry, however, still faces heavy competition, as the truckers who were themselves deregulated in 1980, are becoming increasingly efficient. The truckers share of traffic, at 24.8 percent, is at an all time high.

26. Federal Railroad Administration, Accident/Incident Bulletin, No. 154, Calendar Year 1985, July 1986, p. 5. 1986 figures from the Office of the Federal Railroad Administration.

27. Railroad Facts, op. cit., p. 18.

28. According to the Association of American Railroads, using "Retirement - Replacement - Betterment" accounting methods. The industry has since moved to a different accounting system, based on depreciation.

have continued in the 4 percent range in the years since Staggers was enacted, with a drop to 2.1 percent in the 1982 recession year and reaching 4.7 percent in 1984.

Relative to inflation, the financial condition of the railroads improved steadily after Staggers was enacted: return on net investment was 8.2 percent less than inflation in 1980, and 1.6 percent less in 1982. In 1984 it was 0.5 percent more than inflation. These improvements were crucial during the 1982-1983 recession.[29] Traditionally, the railroad industry has been particularly susceptible to recessions. This time, however, the industry managed to survive the recession, without any major bankruptcies, an almost unprecedented situation.

The railroads' returns on investment, however, remain very low. In 1986, the return was 4 percent.[30] By comparison, the average return on invested capital in U.S. industry last year was 10.7 percent.[31] Thus, while its financial condition has improved since the 1970s, the railroad industy is still struggling.

THE THREAT OF REREGULATION

Not all railroad shippers are satisfied with deregulation. Some feel that the Staggers Act does not protect them from high railroad rates. For the most part, these dissatisfied customers ship coal and other commodities not easily transported by truck. Competition thus is less intense. These critics argue that they are "captive shippers," in that they have no choice but to use railroads and consequently have to pay high rates for railroad service.

Several bills have been introduced in Congress to address these complaints. The leading proposal is the "Consumer Rail Equity Act" (S. 676, H.R. 1393), also known as the "CURE bill" because it is supported by a coalition of shippers known as "Consumers United for Rail Equity." Among other things, this bill would:

1) **Shift the burden of proof** to a railroad to demonstrate that its rates are reasonable, in contrast to the current rules that require the shipper to show that the rates are unreasonable before the ICC can intervene.

2) **Force railroads** to make available certain of their facilities and equipment to a competing railroad at "competitive" rates.

3) **Forbid the ICC from considering** competition from different regions and different products (known as "geographic" and "product" competition) in determining whether a railroad is "market dominant."

Proponents of this legislation argue that these changes would not undo deregulation, only fine-tune it to make it more "fair." The truth is that these changes could jeopardize seriously the gains made by shippers and railroads over the last seven years. More important, such changes are not needed to protect shippers.

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29. See Stephen J. Thompson, "The Profitability of Railroads After Enactment of the Staggers Rail Act of 1980," Congressional Research Service Report No. 85-110 E, May 8, 1985.

30. According to Association of American Railroads figures. The return would have been only 3.5 percent under the old accounting system.

31. Business Week, April 17, 1987, p. 43.

Changing the burden of proof in rate cases, for instance, may seem to be a minor point of legal procedure. But as every lawyer knows, the issue of who has to prove his case is often the most important factor in determining the outcome of a case. Under current law, a complaining shipper has to prove to the ICC that a railroad's rate is unreasonable. Thus the railroads are presumed innocent until proved guilty.

Presumed Guilty. The CURE bill, however, would presume the railroads guilty until proved innocent. The railroad's rates would be viewed as unreasonable until proved otherwise. Thus simply by filing a complaint with the ICC, a shipper could force a railroad into a long and complex proceeding in which it would have to prove its rates were reasonable, a difficult task. Even if the shipper eventually lost, the delays imposed could be very costly to a railroad. The inevitable result would be rates determined more by lawyers and bureaucrats than by the marketplace.

The proposal to require railroads to offer their services to other railroads is also flawed. The bill would limit "joint rates"--rates at which one railroad carries another railroad's traffic to its final destination--to "competitive" levels. The rate is deemed competitive if it does not exceed the variable cost of the service by a higher percentage than does the regular railroad rate.[32] This violates basic principles of justice. Just as it would not be just to force a grocery store to open its property to its competitors at particular rates, it is not just to force railroads to do so. The rates deemed to be "reasonable," moreover, are set at arbitrary levels. More is involved in rate setting than calculating variable costs. As important, for example, is the demand for the service. The CURE proposal would impose by legislative fiat an arbitrary formula for the division of freight revenues among railroads. This should be decided by the railroads involved, based on the circumstances in each case.[33]

Competition in Many Forms. In any case, the ICC recently approved a procedure by which shippers who feel they have been harmed by unreasonably high joint rates, or the lack of joint rates, can seek relief. Under this procedure, the Commission will not permit changes in existing joint rates if it finds them contrary to the competition policy of the Staggers Act or otherwise anticompetitive. Thus, even under current law, shippers are not without recourse.

Lastly, the provision prohibiting the ICC from considering geographic and product competition when determining whether a railroad is "market dominant" and a shipper "captive" would create an unrealistically narrow definition of competition. The fact is, competition comes in many forms. There is direct competition between two railroads in a market and competition between a railroad, trucks, ships, and other modes of transportion. There also is indirect competition, which can be as potent as the direct variety. Example: a coal producer may have access only to a single railroad to ship to market, yet the coal purchaser can buy from a number of sources, all relatively the same distance away. This competition from a different geographic area effectively limits the amount a railroad may charge. If its rates are unreasonably high, less coal will be sold from that area and the railroad will make less money. Similarly, product competition limits railroad rates, as users of coal, for instance, are able to switch to other fuels if railroad rates rise too much. While not as easily quantified as other forms of competition, geographic and product competition restrain the market power of railroads.

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32. The plan would also expand the situations where use of terminal facilities and switching services can be required.

33. For a fuller discussion of these issues, see Charles A. Marshall and Cheryl A. Cook, "Issues of Cost Recovery in the Debate Over Competitive Access," 15 Transportation Law Journal 9 (1986).

DO RAIL DEPENDENT SHIPPERS NEED RATE RELIEF?

Much support for reregulation comes from a perception that certain shippers dependent on railroads are forced to pay unjustifiably high rates. This is a misperception. Almost all types of shippers have seen their rates reduced since deregulation--including coal shippers, the most vocal reregulation supporters. The rates for coal shipments have fallen from an average $12.30 per ton in 1980 to $12.15 per ton today, adjusted for inflation.[34]

Recognizing this, many dissatisfied shippers argue that, while rates have dropped, they have not dropped enough. To evaluate this argument, it is necessary to remember that railroads, as other industries, face two types of costs: "fixed" and "variable." Fixed costs are those incurred by the railroad regardless of the amount of business it does, such as the cost of track and equipment. Variable costs are the additional costs arising from a particular shipment for such things as labor and fuel.

High Fixed Costs. Obviously, a railroad cannot simply charge customers for the variable costs of each shipment, since this would leave nothing for the fixed costs. In railroads, in contrast to many other industries, these fixed costs constitute a very high proportion of total costs, given the need for substantial investment in track and equipment.

Coal shippers argue that they are forced to pay far more than their "fair share" of fixed costs. They point out that shippers of coal and other commodities, for which railroads are the only readily available form of transportation, often are charged rates that are 200 percent or more than the variable costs incurred. On the other hand, they claim, commodities for which there are non-rail alternatives are charged rates that are a much smaller percent of their variable cost.

The Biggest Losers. Such differences, however, are not unfair. There are only two ways that the rates for the rail-dependent shippers can be reduced: by cutting total rail revenues, or by increasing rates for other shippers. Reducing total revenues would drain needed funds from railroads, which are only marginally profitable as it is. Raising rates for other shippers is no more practical. As the railroads know too well, these shippers would ship their goods by truck if rail prices were raised.

Thus, to pay for their high fixed costs, railroads are forced to charge more to customers who are dependent on their services than those who have alternatives. Without such "differential pricing," railroads would lose needed business and funds, resulting in poorer service and higher prices for all their customers. In fact, the biggest losers would be the rail-dependent shippers, including the coal shippers themselves. If the rail system once again were to deteriorate, most shippers would turn to truckers, and rail dependent shippers would face reduced service at prices even higher than they now pay, as fixed costs were spread over a narrower base of customers.

CONCLUSION

The railroad industry, once in a steep decline and facing nationalization or extinction, has enjoyed a remarkable turnaround in the years since it was partially deregulated. Costs have been reduced, service and safety improved, and rates lowered, resulting in a savings of billions of dollars for the U.S. economy.

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34. According to ICC quarterly commodity statistics.

The railroads have been brought back from the brink of bankruptcy, but they are not yet in the clear. The return on investment still is only marginal. These gains notwithstanding, some lawmakers are threatening to stiffen regulation of the industry in the name of "fairer" rates for certain shippers. Such regulation would only undermine the railroads, to the detriment of all shippers. Railroad regulation was devised for the railroads of 1887. It is a disaster for the railroads and shippers of 1987.

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