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DIRECTORATE FOR FINANCIAL AND ENTERPRISE AFFAIRS
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Working Party No. 2 on Competition and Regulation

ROUNDTABLE ON STRUCTURAL REFORM OF THE RAIL INDUSTRY

-- United States --

The attached document is submitted by the delegation of the United States to the Working Party No. 2 of the Competition Committee FOR DISCUSSION under Item IV of the agenda at its forthcoming meeting on 14 February 2005.

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1. The United States government's statutory objectives for the railroad industry stress the efficiency and viability of the industry balanced against the need for "reasonable rates," "fair wages," "public health and safety," and "energy conservation."[1] Congress adopted these objectives when it passed the Staggers Act in 1980. At the time, large segments of the railroad industry had been consigned to bankruptcy, so Congress aimed to revitalize the industry by reducing regulatory oversight.

There are four major freight railroads and one intercity passenger railroad in the United States. The major US freight carriers also face competition from the Canadian railroads (Canadian National and Canadian Pacific) for transcontinental and other traffic; the Canadian railroads have US subsidiaries that also compete for traffic. The freight railroads are vertically integrated while Amtrak is, aside from its ownership of the Northeast Corridor, vertically separated. Other than the Northeast Corridor, Amtrak operates over the freight railroads' infrastructure. The following table lists these companies, their ownership structure, the services they provide, and their owned track miles.

Major US Railroad Companies[2]

Company	Ownership	Services	Owned Track Miles
Burlington Northern	Publicly held equity	General Freight	24,674
Santa Fe CSX	Publicly held equity	General Freight	19,181
Norfolk Southern	Publicly held equity	General Freight	16,964
Union Pacific	Publicly held equity	General Freight	27,388
Amtrak	US Government owned	Intercity Passenger	745

There are also numerous independent freight railroads that operate branch rail lines that feed into the major freight railroads. Often these firms operate on low density routes that the major freight railroads formally abandoned during the reorganizations and regulatory reforms in the 1970s. The small firms frequently operate at lower costs than the major freight railroads were able to achieve on these low density routes. More flexible work rules contribute to the financial success of these small firms. In some instances, local governments or associations of customers assisted in upgrading the tracks that the major freight railroads abandoned.

Several major metropolitan areas have commuter rail services or have subway systems that operate on rails. Nearly all of these systems are owned and operated by state, local, or metropolitan government bodies. Federal subsidies are often received for capital improvements on these systems. Operations often require subsidies from state and local governments. In some areas, these systems have their own tracks while in others they share tracks with freight traffic.

The United States has two railroad regulatory agencies: the Federal Railroad Administration (FRA) and the Surface Transportation Board (STB). Both are housed within the Department of Transportation, a cabinet-level department within the executive branch of the US Government. FRA's regulatory objective is railroad safety. The STB focuses on the limited, residual economic regulation of the railroad industry.

On the freight railroad side of the industry, regulatory reform is largely complete. It has been nearly 25 years since Congress passed the Staggers Act that put in place the current regime. Amtrak's status is more uncertain. It receives a $1.2 billion subsidy each year, which the Bush Administration has targeted for elimination in past years. Amtrak has received its $1.2 billion subsidy for Fiscal Year 2005, which ends September 30, 2005.

[1] USCA 49 § 10101.
[2] Association of American Railroads, *Railroad Facts*, October 2004, pp. 70, 71, 74, 76, 77.

List of relevant books and papers:

Braeutigam, Ronald R. “Consequences of Regulatory Reform in the American Railroad Industry.” *Southern Economic Journal,* Vol. 59, No. 3 (Jan. 1993) pp. 468-480.

Ellig, Jerry. "Railroad Deregulation and Consumer Welfare," Journal of Regulatory Economics, Vol. 21, No. 2 (2002) pp. 143-167.

Friedlaender, Ann F., Ernst R. Berndt, Gerard McCullough, John R. Meyer & Ronald R. Braeutigam. “Governance Structure, Managerial Characteristics, and Firm Performance in the Deregulated Rail Industry.” *Brookings Papers on Economic Activity, Microeconomics,* Vol. 1992 (1992), pp. 95-186.

General Accounting Office. *Railroad Regulation: Current Issues Associated with the Rate Relief Process*. GAO/RCED-99C46 (1999).

General Accounting Office. *Railroad Regulation: Economic and Financial Impacts of the Staggers Rail Act of 1980*. GAO/RCED-90-80 (1990).

General Accounting Office. *Railroad Regulation: Changes in Railroad Rates and Service Since 1980*. GAO/RCED-99-93 (1999).

General Accounting Office. *Railroad Regulation: Changes in Freight Railroad Rates from 1997 through 2000*. GAO/RCED02-524 (2002).

Grimm, Curtis & Clifford Winston. “Competition in the Deregulated Railroad Industry: Sources, Effects, and Policy Issues.” *Deregulation of Network Industries: What’s Next?* Sam Peltzman & Clifford Winston, editors. AEI-Brookings Joint Center for Regulatory Studies (2000), pp. 41-71.

MacDonald, James M. & Linda C. Cavalluzzo. “Railroad Deregulation: Pricing Reforms, Shipper Responses, and the Effects on Labor.” *Industrial and Labor Relations Review,* Vol. 50, (Oct., 1996) pp. 80-91.

National Commission on Productivity and the Council of Economic Advisors, “Improving Railroad Productivity: Task Force on Railroad Productivity,” Executive Office of the President (November 1973).

Surface Transportation Board. Office of Economics, Environmental Analysis, and Administration. “Rail Rates Continue Multi-Year Decline.” December 2000.

Wilson, Wesley W. “Market-Specific Effects of Rail Deregulation.” *The Journal of Industrial Economics*, Vol. 42, No. 1 (Mar., 1994) pp. 1-22.

Winston, Clifford. “Economic Deregulation: Days of Reckoning for Microeconomists.” *Journal of Economic Literature*, Vol. 31, No. 3 (Sept., 1993) pp. 1263-1289.

2. Aside from safety, which is directly regulated by the FRA, US railroad policy predominantly relies on competition to achieve its objectives. Amtrak’s rates are completely deregulated and thus constrained only by inter-modal competition (private automobile, bus, and passenger airline) and the level of subsidization that Congress is willing to provide. Like most other passenger railways, Amtrak’s costs exceed its revenues, and relies on government subsidies to stay in business.

For the freight railroads, US policy largely relies on highway carriage, internal waterway carriage, and intra-modal competition to achieve its objectives. Less than twenty percent of freight traffic is subject to regulation.[3] US regulation exempts any contract shipment and certain commodities and services that have powerful highway competition. Notable among these exempted commodities and services are containers and trailers on flatcars, boxcars, non-ferrous recyclables, and certain agricultural products.

Intra-modal railroad competition is largely between vertically integrated companies, although in some instances a freight railroad operates over lines it does not own. This situation arises usually from merger conditions to ensure competition or agreements with small branch lines. These branch lines are sometimes segments of the major carrier that a smaller entity can operate without union work restrictions.

During the last twenty years railroad rates have been uniformly falling while productivity has been rising. A Surface Transportation Board study found that rail rates had fallen 45.3% between 1984 and 1999.[4] The following table illustrates the growth in railroad productivity:

Railroad Productivity Since the Staggers Act (1980)[5]

	1980	1985	2003
Net Ton Miles per Train-Hour	40,392	56,343	60,356
Revenue Ton Miles per Gallon of Fuel	235	282	405
Revenue Ton Miles per Employee Hour	863	1,196	3,805

The STB exists as the regulatory backstop where inter-modal and intra-modal competition are not effective and a railroad has market power. Such circumstances occur for bulk shippers (coal, some chemicals, and some agricultural products) who cannot use highway carriage and do not have economical access to an inland waterway or another railroad. In these instances, if the shipper believes a rate is unreasonable, it can bring a rate complaint to the STB for review.[6]

Since deregulation, the US freight railroad industry generally has not received government subsidies, but there are exceptions. In the 1970s, when several major eastern railroads went bankrupt, the US government took ownership control and restructured them into a single entity, Conrail. In 1987, the US government privatized Conrail and received $1.9 billion from the new stockholders. In 1997, Conrail was absorbed by CSX and Norfolk Southern. Recently, federal, state, and local governments have been partnering with the freight railroads in an effort to reduce congestion on the passenger and freight transportation infrastructure. Examples include the Alameda Corridor in Los Angeles and the Chicago Region Environment and Transportation Efficiency project. These projects are aimed at reducing local congestion rather than enhancing inter-modal competition.

[3] US General Accounting Office, Railroad Regulation, Current Issues Associated with the Rate Relief Process, February 1999, p. 16.

[4] Surface Transportation Board. Office of Economics, Environmental Analysis, and Administration. ARail Rates Continue Multi-Year Decline.” December 2000.

[5] Association of American Railroads, *Railroad Facts*, October 2004, pp. 38, 40, 41.

[6] The STB standard is stand-alone cost. The STB determines what a hypothetical new, optimally efficient carrier would need to charge the complaining shipper if such a carrier were to design, build and operate a system to serve only that shipper and other selected traffic. The defendant railroad is then allowed to charge no more than such a hypothetical carrier would charge to cover all its costs including capital and construction.

3. The US railroad industry is largely deregulated. Amtrak has no regulatory oversight for its prices and services. The freight railroads are subject to very limited regulation. Shippers can file rate complaints with the STB only if they do not have access to another railroad, highway carriage is not a viable option, and they lack economical access to a waterway. Shippers can also lodge service complaints with STB, and the STB has issued service orders to break severe rail congestion such as in Houston in 1997. But STB service orders are extremely rare. The STB does not review railroad investment. The STB merely reports annually the freight railroad industry's cost of capital and if the companies are achieving their cost of capital. US regulatory policy aims at creating a climate in which the freight railroads can flourish and attract the necessary capital from private sources. However, since 1980, with a handful of exceptions, the freight railroads, while profitable, have failed to meet or exceed their cost of capital.

The FRA is responsible for rail safety. The FRA sets safety standards for rail equipment. It investigates accidents on the rail lines and at railroad crossings.

The major government subsidies to the US railroad industry are the $1.2 billion annual federal payment to Amtrak to maintain inter-city passenger service, and the federal, state, and local subsidies for commuter rail service. Amtrak had a more than $1 billion operating loss in 2003, so it could not maintain operations without this subsidy. Congress reviews this subsidy during the annual budget cycle. The next largest subsidy is CREATE (Chicago Region Environmental and Transportation Project). The US freight railroads are contributing $210 million to a $1.5 billion project, which will create five rail corridors (including one passenger), 25 new grade separations, six rail-to-rail "flyovers" to separate passenger and freight services and conversion of an elevated line to public use. This is a multi-year project. Because the project provides many public benefits, only a fraction of the government contribution could be deemed a pure subsidy to the freight railroads.

4. Track, stations, power, and marshalling yards are all included in the infrastructure that vertically integrated rail companies provide to non-integrated or unrelated train companies using the infrastructure. Agreements to provide access are typically voluntary – often reciprocal between two vertically integrated companies – and access is provided at an unregulated, privately contracted price, often a simple variable usage charge, sometimes with a rental component as well. In cases in which the STB mandates access, this is almost always a condition for the approval of a merger between two vertically integrated rail companies, where the STB is seeking to maintain the number of companies offering service to shippers at particular locations who would otherwise lose one carrier as a result of the merger.

Almost all of the infrastructure is owned by vertically integrated freight railway companies. Passenger service is provided by publicly subsidized Amtrak, usually by passenger trains operating on the infrastructure of the freight railway companies under voluntary access agreements. Amtrak owns some infrastructure in the Northeast, where it operates as a vertically integrated passenger rail company, occasionally providing infrastructure access to the vertically integrated freight rail companies under voluntary, private contracts.

5. In general, the infrastructure owner/operator – usually a vertically integrated freight railway – is required to provide access to the infrastructure by independent train operating companies only as a regulatory condition imposed by the STB to preserve competition for particular shippers following a merger of two railway companies.

It is quite common for the infrastructure owner/operator to reach a voluntary agreement with another vertically integrated freight railway to provide access for the trains of that company to the infrastructure of the first company. Such an arrangement may take place temporarily, during infrastructure repairs or improvements, for example, or over a multi-year period, in order to reduce costs or increase

efficiency. Such arrangements between two vertically integrated freight railways are often reciprocal. All major US railways take part in such arrangements for voluntary access.

With very little mandated access to rail infrastructure, competition in the US railway sector may take one of three forms:

a) intermodal competition, where motor or water carriers compete directly with rail carriers for the shipments;

b) end-to-end competition, where two or more vertically integrated freight railways (perhaps along with other connecting railways) may compete to carry the same cargo from origin point A to destination point B; and

c) "source" (or "geographic") competition, where two or more vertically integrated freight railways compete to carry the same cargo from origin point A to different destination points C, D, and E, and/or two or more vertically integrated freight railways compete to supply competing cargos to destination point B from different origin points F, G, and H.

6. Over the past several decades, there have been a large number of mergers among the vertically integrated freight railways in the US. Most recently, as the number of independent railways servicing particular markets has been continually reduced, the Antitrust Division of the Department of Justice has opposed some merger proposals and sought the imposition of significant protective conditions on others. In general, the STB approved mergers while imposing some trackage rights conditions until the most recent Class I railway merger proposal, when it announced a new, stricter policy to preserve the remaining competition.

The following two articles are based on economists' expert testimony in two of the largest proposed merger cases – the Santa Fe and Southern Pacific Railways, which the Interstate Commerce Commission (ICC, the predecessor to the STB) rejected, and the Union Pacific and Southern Pacific Railways, which the STB permitted with conditions.

Kwoka, John E., Jr., and Lawrence J. White, "Manifest Destiny? The Union Pacific and Southern Pacific Railroad Merger," in Kwoka and White, eds., *The Antitrust Revolution: Economics, Competition, and Policy*, 4th ed., New York: Oxford University Press, 2004.

Pittman, Russell, "Railroads and Competition: The Santa Fe/Southern Pacific Merger Proposal," *Journal of Industrial Economics* 34 (1990), 25-46.

Other articles discussing these mergers include the following:

Breen, Denis A. "The Union Pacific/Southern Pacific Rail Merger: A Retrospective on Merger Benefits," Review of Network Economics, Vol. 3, No. 3 (September 2004) pp. 283-322.

Karikari, John A., Stephen M. Brown, and Mehrzad Nadji. "The Union Pacific/Southern Pacific Railroads Merger: Effect of Trackage Rights on Rates," Journal of Regulatory Economics, Vol 22, No. 3 (2002) pp. 271-285. (This is the published version of a GAO study.)

There have been no publicly announced investigations by the antitrust authorities in recent years of allegations of either collusive behavior or monopolization in the freight railways sector. Concerns have occasionally been expressed about collusive outcomes from the rate negotiations that accompany agreements to interline shipments between two railways.

The STB sometimes receives complaints from shippers that they are economically "captive" to a single rail carrier and are being charged excessively high tariffs for their traffic. These complaints are usually made under the rail regulation statutes, not the antitrust statutes, though the alleged violations have clear parallels under the two sets of statutes. The STB has ordered relief to complaining shippers on a case-by-case basis when the standards that it has imposed for regulatory intervention are met.