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HEARING ON RAILROAD REVENUE ADEQUACY

Surface Transportation Board

Docket No. EP 761 & 722

Prof. Joseph P. Kalt

John F. Kennedy School of Government
Harvard University

Raymond Atkins

Sidley Austin

On Behalf of
Association of American Railroads
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Economic and Policy Foundations for Sound Rail Rate Regulation



Overview

I

The “mimic competition” principle

II

Proper and improper measurement of revenue adequacy

III

Uses and misuses of revenue adequacy in railroad regulation

IV

Smart Simplification: Improving the capacity of regulation to mimic competition for all traffic



The “Mimic Competition” Principle



Allow competition to set rates where competition is present; use regulation to mimic competitive prices where competition is absent



The Staggers framework recognizes that rail networks are:

- Subject to competition across wide swaths of the network, but...
- ...with pockets of market power



“Mimic Competition” is deeply embedded in the Board’s framework

- SAC is the “mimic competition” principle
- Staggers wisely rejects “old-style” rate-of-return, earnings-triggered regulation

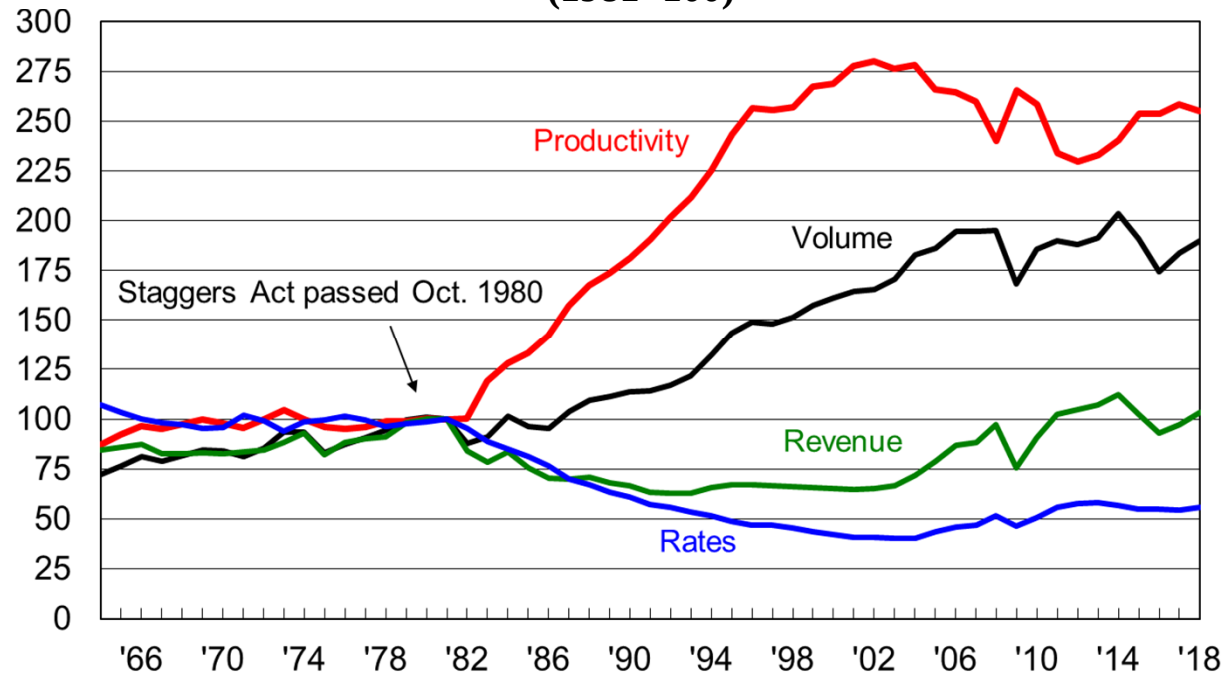


The “mimic competition” framework is the heart of the rail renaissance



The “Mimic Competition” Framework Is the Heart of the Rail Renaissance

RAIL RATES, PRODUCTIVITY, VOLUMES & REVENUE: 1964-2018
(1981=100)



"Rates" are inflation-adjusted revenue per ton-mile. "Volume" is ton-miles. "Productivity" is revenue ton-miles per constant dollar operating expense. Source: AAR



What Does “Mimic Competition” Mean – and Not Mean – in the Rail Industry?



The rail industry is subject to *massive economies of scale and scope*

- Over vast portions of the country, it would be wasteful to operate multiple railroads
- Customers inherently *share* network facilities and the costs of those facilities



What does competition look like under economies of scale and scope?

- “Contestability”: Multiple firms *contest* to build and run the winning system
- To cover the shared costs of a *sustainable* network, customers pay *differential prices*



Under rail’s economies of scale and scope, competition does NOT mean...

- Multiple firms competing everywhere
- Prices pushed to narrowly-calculated marginal costs
- Customer-controlled network access and/or routings

II

Properly Measuring *Revenue Adequacy*



Accounting returns on the book value of net investment (ROI) cannot reliably identify revenue adequacy



Accounting revenue “over-adequacy” is the norm across industries



Coherent measurement of revenue adequacy uses replacement cost

- This is not a matter of principled disagreement
- The Board’s SAC framework is properly a replacement cost framework

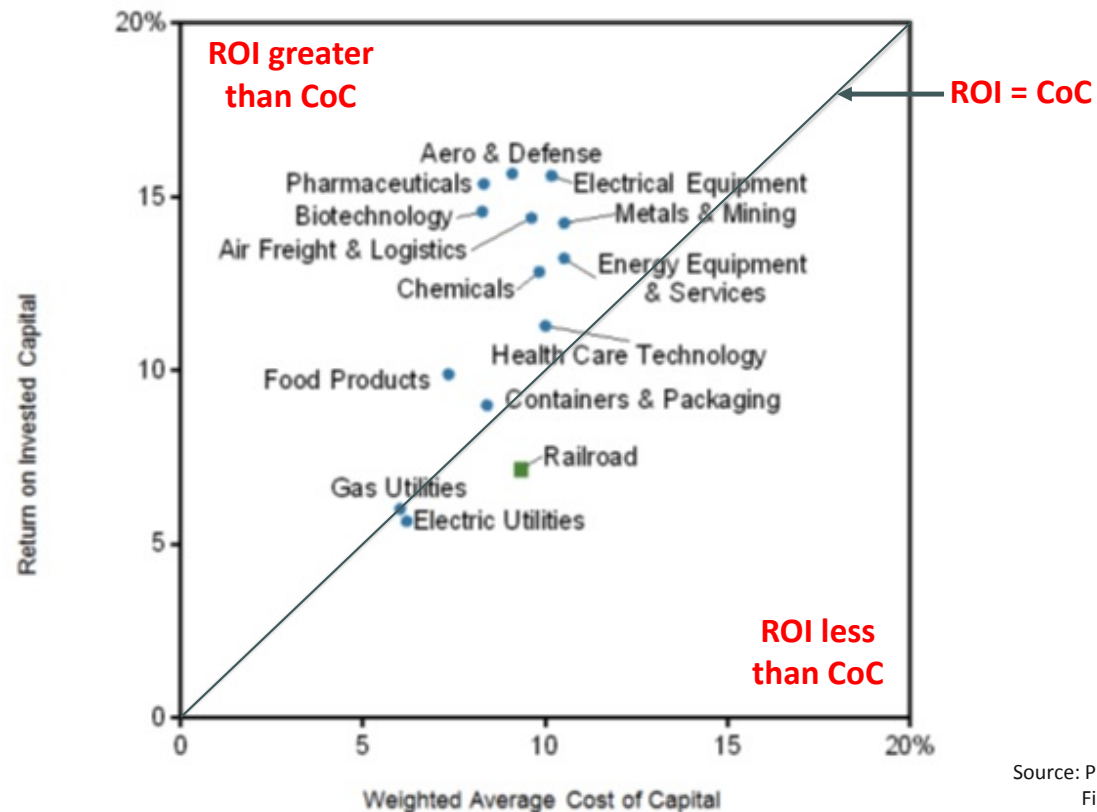


...But, neither *book accounting* nor *economic* revenue adequacy can reliably identify above-competitive pricing



Revenue “Over-Adequacy” Is the Norm Across Industries

Weighted Average Cost of Capital and ROI by Industry, 10-Year Averages (2004-13)



Source: Parthenon utilizing Bloomberg data; see Kalt VS, Figure 3 (Firms in S&P 500 in 2014)



Uses and Misuses of Revenue Adequacy



The “sitting duck” problem: A long-lived, sunk capital network invites regulatory opportunism; a “sustain revenue adequacy” policy is protection



Revenue adequacy “triggers” for rate constraints are distortionary

- General principle: If increased earnings trigger rate constraint, regulation creates incentives to avoid triggering the constraints
- Earnings caps & constraints were the economic essence of now-discredited “old-style” franchise utility regulation



Assessing the Task Force’s Proposals

- The “Revenue Increase Constraint” (RIC) would distort investment, operations and pricing
- “Access” triggers would distort and disrupt



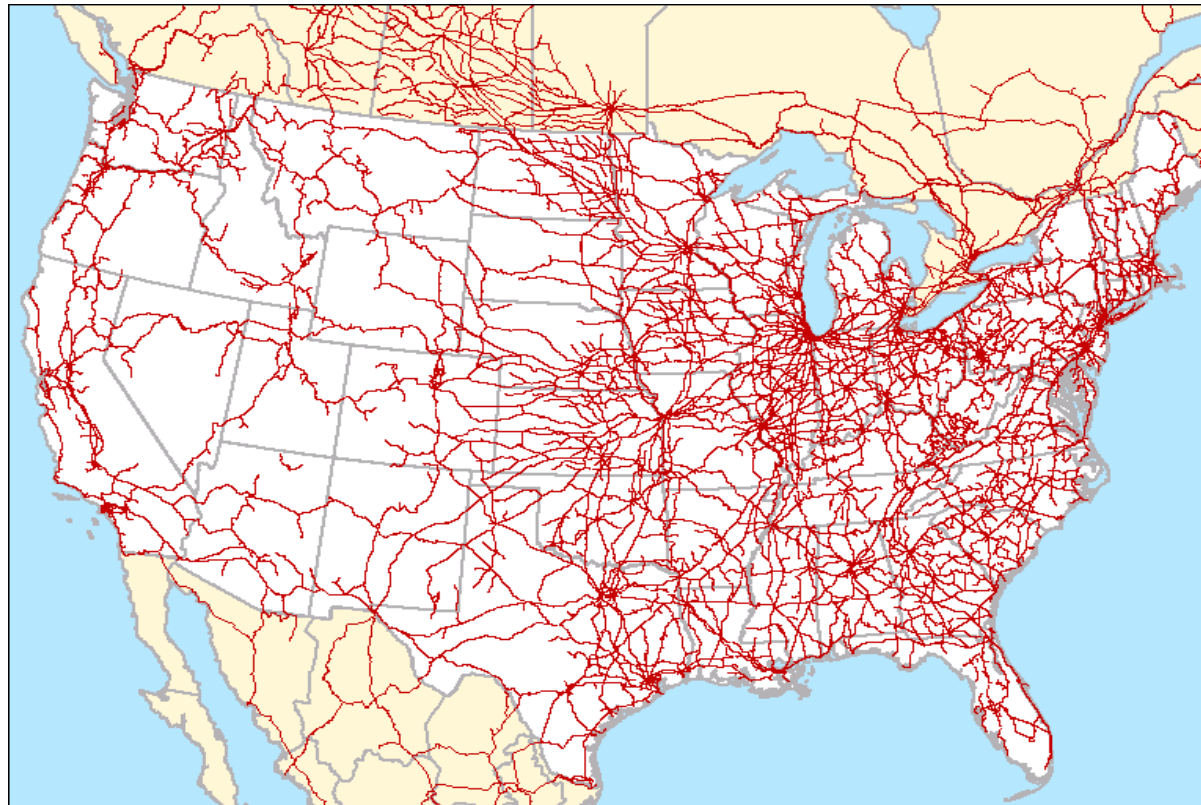
Revenue Adequacy (ROI) Constraints (In)famously Create Distortions

“Briefly, rate-of-return regulation gives the firm incentives to misreport cost allocations, choose an inefficient technology (in some cases), undertake cost-reducing innovation in an inefficient way, underproduce in a noncore market, price below marginal cost in a competitive market which happens to be included in the set of core markets regulated by an aggregate rate-of-return constraint, and view diversification decisions inefficiently.”

Braeutigam, Ronald R., & Panzar, John C, “Diversification Incentives Under ‘Price-Based’ and ‘Cost-Based’ Regulation,” *RAND Journal of Economics*, vol. 20 no. 3, 373-391 . (1989) at p. 390.



Customer Control of Access or Routing Is Especially Poorly Suited to Congestible, Non-Linear Networks with Non-Fungible Traffic



IV

Smart Simplification



General Principle: Don't throw the baby of SAC, "mimic competition" ratemaking out with the dirty regulatory bath water



Rebuttable once-and-for-all decisions on recurring, case-common issues:

- Treatment of equity flotation costs, real estate acquisition costs, taxes, bonus depreciation, debt amortization, etc.
- Choice of inflation indices



Standardization of recurring matters, such as:

- G&A costs, construction costs (e.g., ties, earthworks, ballast, rail), ancillary facilities
- Selection of traffic groups, cross-over traffic, operating plans



Utilization of third-party experts and technical conferences

The Proposals Are Unlawful



Three Different Revenue Adequacy Constraints



System-Wide Earnings Constraint



Forced Competitive Access



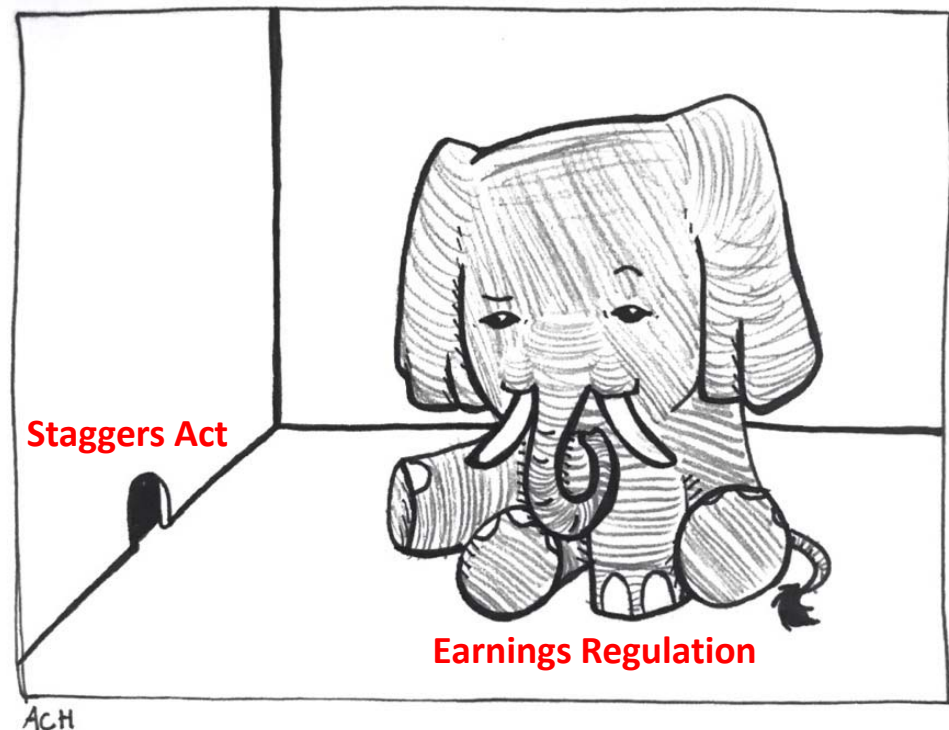
Rate Freezes



System-Wide Earnings Constraint

“Congress ... does not alter the fundamental details of a regulatory scheme in vague terms or ancillary provisions—it does not, one might say, hide elephants in mouseholes.”

Whitman v. Am. Trucking Assoc., 531 U.S. 457, 468 (2001).





What Does the Statute Say?

- Continuing duty to assist railroad industry achieve revenue adequacy.
- Defines revenue adequacy to include an “economic profit”

“... plus a reasonable and **economic profit** or return (or both) on capital employed in the business.” 49 U.S.C. 10704
- Permitted revenue adequate carriers to increase rates 6% above inflation. 49 U.S.C. 10707a(c)(1) (1982)



ACC's Proposal Is Earnings Regulation

Key Features of Earnings Regulation

1. Cost of capital treated as revenue requirement
2. System-wide earnings driven to cost of capital
3. Rate relief tied to revenue from competitive traffic
4. Discourages innovation and efficiency

ACC's Proposal





Section 10705 Offers No Support

(a)(1)The Board may, and shall when it considers it desirable in the public interest, prescribe through routes, joint classifications, joint rates, the division of joint rates, and the conditions under which those routes must be operated, for a rail carrier providing transportation subject to the jurisdiction of the Board under this part.

(2)The Board may require a rail carrier to include in a through route **substantially less than the entire length of its railroad** and any intermediate railroad operated with it under common management or control if that intermediate railroad lies between the terminals of the through route **only when**—

- (A) required under section 10741, 10742, or 11102 of this title;
- (B) inclusion of those lines would make the through route unreasonably long when compared with a practicable alternative through route that could be established; or
- (C) **the Board decides that the proposed through route is needed to provide adequate, and more efficient or economic, transportation.**

The Board shall give reasonable preference, subject to this subsection, to the rail carrier originating the traffic when prescribing through routes.



Forced Competitive Access

“Our decision is, in our view, mandated by the law.”

Central Power & Light Co. v. S. Pac. Transp. Co., 1 S.T.B. 1059, 1073 n.21 (served Dec. 31, 1996)

“We have not found even the slightest indication that Congress intended the Commission ... to conform the industry more closely to a model of perfect competition.”

Midtec Paper Corp. v. United States, 857 F.2d 1487, 1507 (D.C. Cir. 1988)



Rate Increase Constraint

- RIC would have unintended consequences and might well be transformed over time into utility-style earnings regulation.
- RIC would assume a rate is unreasonable without any analysis of the facilities and services needed to serve that customer. That assumption would be unlawful.

The STB Should Abandon the Revenue Adequacy Constraint



All proposals rest on a deeply flawed foundation.

I

All assume accounting returns above cost of capital should trigger increased federal control over rates or routes.

II

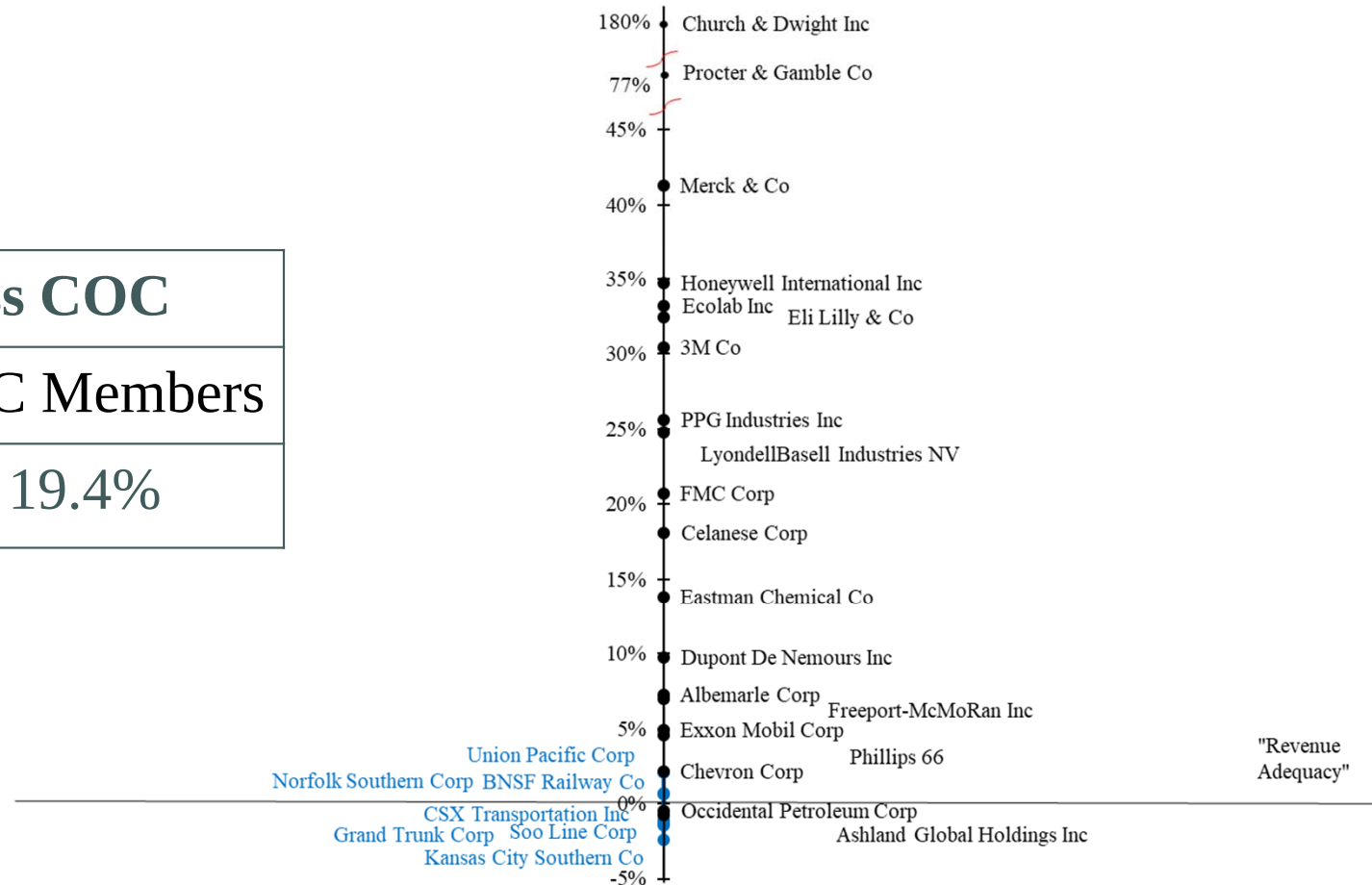
All demand the agency act to constrain railroad earnings at or near the cost of capital.

III

All overlook the known measurement errors in the STB's annual revenue adequacy findings.

ROI (using STB Method) less COC
For ACC Members included in the S&P 500 and Class 1 Railroads
Simple Average over 2006-2018

Median ROI less COC	
AAR Members	ACC Members
-1.1%	19.4%



Source: V.S. of Murphy and Zmijewski, Exhibit 1

Note: Simple average of annual values. For companies with data with less than full coverage, the average is taken over the years available.