

Comment on STB Docket No. EP 711 (Sub-No. 2) Reciprocal switching for inadequate service

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While many rail researchers were encouraged at the prospect of changes to extant reciprocal switching regulations that would shift more control of the process to shippers, I was extremely disappointed at what the STB has proposed as the new reciprocal switching process. To my interpretation, the new regulations will give a novel opportunity for Class 1 railroads to practice what economists refer to as first degree price discrimination, whereby rates for similar (and similarly costing) firm outputs can be effectively tailored to each customer's individual demand or willingness to pay for that output. Under the new regulations, this ability represents a distinct improvement for railroads over current discriminatory pricing schemes, whereby customers are mostly distinguished by general characteristics such as location, level of transportation competition, commodity moved, etc. The latter is referred to as third degree price discrimination and is a common business practice that is not as distressing for the customer/shipper because without exact knowledge of individual willingness to pay (as now seems more likely under the new reciprocal switching regulations), railroads currently cannot extract all the transactional surplus.

The new regulations and associated metrics permit railroads to withhold service on a temporary basis, while concurrently adjusting their rate and service offers to individual shippers. This in turn allows the railroad more flexibility to better find the economic "tipping" point at which the shipper is revealed to just be able and willing to pay, in effect identifying the point where the railroad is extracting most if not all the surplus from the transaction. By focusing reciprocal switching away from rate regulation and towards output regulation, the STB has effectively offered railroads new ways to seek out the highest rate they can charge for a given service to a shipper. While service levels are important to shippers, the vast majority of the cases adjudicated by the STB over the past 40 years relate to contested rate issues, not service issues.

What I find fascinating is that both the industry and the Board well knows there was a recent documented natural experiment in Canada involving a similar policy to reciprocal switching. I urge that the STB more closely examine what went right and what went wrong in this experiment, fearing this has not been done to date or has been obfuscated by the Canadian railroads (noting that the 600+ page AAR submission on reciprocal switching covers some of what occurred, but the discussion is short and of course critical of every outcome). In effect, Canada possesses a long-standing and similar policy known as extended interswitching. In 2014, as a response to significant shipping concerns and drawing upon some prior published research of mine, major changes were made to the policy to try to expand inter-rail competition. These changes were active from 2014 through 2017 in the hope of improving the transportation situation for many constipated commodity shipments that relied heavily on railroads for their long-distance movements.

As I testified to the STB in 2022, the limited data made available to me on the 2014-2017 extended interswitching experiment highlighted two operational points about the attempt to increase inter-rail competition: 1) the new policy did not lead to many actual interswitches, but by 2017 indications were that rates has dropped slightly while service appeared to be more reliable than previously (hinting strongly that the new market was becoming contestable); and 2) it took some time for shippers to understand and utilize the new regulations, meaning three years as a policy duration was likely not quite long enough for this new market to approach a competitive equilibrium. The data also showed that the easier availability of interswitching for shippers did not overwhelm rail capacity nor did it ruin the Class 1 railroads, but instead it seems to have at least temporarily provided the affected Canadian shippers some rate relief as well as more reliable service.

Another oddity to me in the STB notice was the effective “hand waving” over the regulated pricing of any actual reciprocal switches. In most of the infrastructure regulation and access literature, the setting of “fair and reasonable” access prices is a major point of concern and has led to a large literature on what constitutes optimal pricing for the use of infrastructure that is not owned by the user. To this end, the theoretical superiority of so-called Ramsey pricing for access is well established (including the popular Vogelsang-Finsinger pricing mechanism) and the former was even part of early ICC discussions over potential regulated pricing scenarios. But without delving further into how actual reciprocal switches ought to be priced, I will only say that this “hand waving” on the tricky access pricing issue indicates to me that the STB realizes that as written, their new reciprocal switching regulations will be used just about as often as the old ones.

As written, the implementation of a reciprocal switch still leaves the onus of its potential use on the railroad and the STB, and not the shipper. The use of output performance metrics (unfortunately set at the time of some of the worst Class 1 performances of the past decade, if not longer) to enact reciprocal switching not only supports the unintended discriminatory pricing consequences described above, it also leaves the shipper as a passive rather than active participant in the process, providing them with little to no leverage in using the new policy as an economic negotiation tool with railroads. But if the policy is to be saved and have teeth, meaning being designed and implemented in a similar manner to what occurred in Canada where the onus was on shippers to use the policy, with the regulator subsequently approving its use (or not), correctly designed reciprocal switching means shippers need to be empowered, and gain leverage in negotiating their future transactions with railroads, who in return will need to offer improved levels of rates and service if they want to retain their transportation market share. That is how a well-functioning market is supposed to work, after all.

Yours sincerely;

A handwritten signature in grey ink, appearing to be 'J. Nolan', with a long horizontal stroke extending to the right.

Over the past two decades, Dr. James Nolan has published considerable research on transportation economics and policy. He currently serves as an editor for two major transportation journals. James is a full professor in the Department of Agricultural and Resource Economics at the University of Saskatchewan in Canada.