

Comments of the International Center for Law & Economics, Growth in the Freight Rail Industry

Docket No. EP 775

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I. Introduction

In its request for testimony related to the Sept. 16 and 17, 2024 hearings, the Surface Transportation Board (STB) has asked for commentary on "how the industry has grown and intends to grow in the future."¹ While this line of inquiry reflects the STB's interest in understanding industry dynamics, it raises questions about the most effective approach to fulfilling the STB's regulatory role under the Staggers Rail Act of 1980 ("the Act").

The STB's focus on the rail industry's growth plans merits careful consideration. It is important to reflect on whether scrutinizing or directing industry growth falls within the purview of a regulatory agency. The STB's primary role, as defined by its organic statute, is to ensure that firms behave within appropriate constraints, rather than to guide commercial strategies. Additionally, the Act's Rail Transportation Policy section and operative language do not explicitly mention industry growth as a goal. Instead, the Act emphasizes that the STB should make an "adequate and continuing effort" to provide rail carriers with adequate revenue levels to earn "a reasonable and economic profit or return (or both) on capital employed in the business."² This suggests that the industry should be guided primarily by market forces, rather than regulatory direction.

By concentrating on growth plans, the STB may inadvertently be missing opportunities to foster technological and business-model innovation crucial to achieve the Act's policy goals of creating a sound, safe, and efficient rail-transportation system. Such innovation and experimentation are essential to realize these objectives. In examining these issues, we aim to offer constructive feedback that may help the STB refine its regulatory approach to align more closely with the Act's intended purposes.

The following sections will elaborate on each of these points, providing evidence and arguments based on economic principles, industry examples, and the Act's statutory language. Our goal is to contribute to a productive dialogue on how best to achieve the STB's important regulatory objectives.

II. STB Focus Should Center on Where Regulation Impedes Profitability

The STB's concern with the decline in carload volumes over the past decade, while generally understandable, is misguided in at least two respects. First, the STB's remit is not to judge private firms' commercial strategies, but to determine the proper, minimal regulatory environment necessary, pursuant to the Act. Second, "growth" of rail carriage, however judged, is not the same thing as profitability, the actual metric by which firms should be judged when determining their long-term viability.

¹ Surface Transportation Board, Notice of Public Hearing, Docket No. EP 775, 89 FED. REG. 135 (Jul. 15, 2024).

² 49 U.S.C. § 10704(a)(2).

Following these two points, the correct question for the STB to ask is the extent to which existing regulations prevent rail carriers from experimenting with business models and technologies that could help them to achieve long-term profitability. It is inappropriate and outside the proper scope of a regulatory agency like the STB to question firms about their plans for “growth.”

A. The Staggers Rail Act Calls for Stanching Overregulation

The Staggers Rail Act was designed to allow market forces to guide the rail industry's development, with minimal regulatory intervention. A primary purpose of the Act is “[t]o allow, to the maximum extent possible, competition and the demand for services to establish reasonable rates for transportation by rail.”³ Thus, market forces, and not regulatory fiat, are and should remain the primary drivers of rail carriers’ commercial decisions. Indeed, as Bernard Sharfman elaborates, a proper interpretation of the Act must consider the overall deregulatory thrust of its provisions:

Based on an analysis of the fifteen policy statements found in the Rail Transportation Policy section of the Act, it is clear that minimizing regulation in the freight rail industry is the primary objective of the Act. This is supported by viewing the Act in its historical context and, most importantly, the Act’s operative language.⁴

Other provisions of the Act that empower the STB to promulgate rules or otherwise conduct business derive from this primary objective.⁵ That is to say, the STB’s ability to act, whether through informal hearings or formal rulemaking, must always be constrained by the goal of minimizing onerous regulations on rail carriers.

Given this background, the STB’s current hearings are curious. Inquiring about how private firms plan to grow suggests an interest in intervening in the firms’ core conduct—their selection of business strategies, technologies, etc.—that go beyond the limited remit of the Act to, *e.g.*, ensure reasonable compliance with common-carriage requirements, permitted rate regulation, and so forth. So long as a firm’s output complies with the STB’s properly crafted regulations, it is inappropriate to inquire into “growth” strategies.

Beyond the fact that it exceeds the proper scope of STB authority, questioning firms about their growth plans may lead to unintended consequences. If viewed as a form of jawboning from their regulator, it may lead companies to focus on short-term “growth” metrics—such as adding unprofitable service or hiring more personnel than necessary—rather than on long-term profitability.

B. Profitability Is the Proper Metric to Evaluate Firms

Even on its own terms, the STB’s focus on “growth” is misplaced. It's crucial to recognize that raw volume growth is not always the most relevant metric to assess industry health or economic

³ 49 U.S.C. § 10101(1)

⁴ Bernard S. Sharfman, *Using 'Enacted Purposes' to Interpret a Regulatory Statute*, SSRN (Jul. 29, 2024), at 4, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4905077.

⁵ *Id.* at 3.

efficiency. In many cases, profitability and returns on invested capital (ROIC) are more important indicators of either a firm’s or an industry’s performance, as well as how they allocate resources. In other words, profit-maximizing firms are interested in increasing sales volumes only inasmuch as the increased volumes are associated with an increase in ROIC or profits.

In industries with high fixed costs and capital intensity, such as freight rail, firms often focus on maximizing profitability, rather than pure volume growth. This approach aligns with the economic concept of allocative efficiency, where resources are directed to their most valuable uses.⁶ Like all firms, railroads have limited resources with which to make their investments. While profitability is a necessary precondition for investment, not all profitable investments can be undertaken.

Among the universe of potentially profitable projects, firms are likely to give priority to those that promise greater returns on investment relative to those with lower ROIC. Thus, any evaluation of railroad investments must examine not only whether a given investment is likely to be profitable, but also how its expected returns compare to other investment opportunities. For railroads, this may mean focusing on high-margin traffic, optimizing network efficiency, or investing in technology to reduce operating costs. Such strategies can lead to improved financial performance and long-term sustainability, even if overall carload volumes stall or decrease.

Recent empirical research by Susanna Mansikkamäki on the relationship between firm growth and profitability finds: “A carefully planned growth strategy that avoids non-profitable growth becomes increasingly important with age and size.”⁷ Mansikkamäki concludes: “[L]arger firms may have a size-based competitive advantage but only if they stay profitable. When profitability drops, the advantage can become a disadvantage.”⁸

In the context of the rail industry, profitability is particularly important given the capital-intensive nature of the business. Railroads require significant ongoing investments in infrastructure maintenance and upgrades. Without sustainable profitability, these investments become difficult or impossible to make, potentially leading to deterioration in service quality and safety. Indeed, even the Act itself contemplates regulated carriers’ profitability as a concern, stating that one its goals is to “promote a safe and efficient rail transportation system by allowing rail carriers to earn adequate revenues.”⁹

By contrast, policies aimed at promoting volume growth might have unintended consequences. For example, encouraging unprofitable traffic could lead to underinvestment in infrastructure and reduced service quality for all customers. Moreover, a single-minded focus on volume growth might

⁶ See, WILLIAM J. BAUMOL & ALAN S. BLINDER, MICROECONOMICS: PRINCIPLES AND POLICY (6th ed., 1994), 245-246.

⁷ Susanna Mansikkamäki, *Firm Growth and Profitability: The Role of Age and Size in Shifts Between Growth–Profitability Configurations*, 19 J. BUS. VENTURING INSIGHTS e00372 (Jun. 2023).

⁸ *Id.*

⁹ 49 U.S.C. § 10101(3)

divert attention and investments from innovations that could improve efficiency, reduce operating costs, and place downward pressure on freight rates.

C. STB Should Investigate Regulations that Interfere with Profitability

The Staggers Rail Act was enacted in 1980 in response to a ruinous state of affairs in the rail industry, largely due to years of overregulation.¹⁰ As President Jimmy Carter said when signing the Act into law: "At the heart of this legislation is freeing the railroad industry and its customers from... excessive [regulatory] control."¹¹ The Act therefore explicitly focuses on both deregulation¹² and ensuring that carriers receive adequate revenue.¹³

In a recent working paper, Bernard Sharfman recommends an approach to statutory interpretation that can better align the STB's activity with the Act's overall aims. He argues it should be viewed as an optimization problem, where regulation is to be minimized subject to the constraints found in the Rail Transportation Policy section.¹⁴ Sharfman notes:

If the fifteen listed policy statements were all weighted equally, then it would be problematic in how and when to apply them. Conflicts would constantly arise. However, reading the Rail Transportation Policy section in its historical context makes clear there is one and only one primary objective— minimizing regulation in the freight rail industry.¹⁵

Indeed, as Sharfman notes, courts have approached the Act in a very similar manner. In *CSX Transp. v. U.S.*, the D.C. Circuit held that:

Congress made its [deregulatory] intent absolutely clear by adopting a statement of Rail Transportation Policy section, that began as follows:

(1) to allow, to the maximum extent possible, competition and the demand for services to establish reasonable rates for transportation by rail; (2) to minimize the need for Federal regulatory control over the rail transportation system and to require fair and expeditious regulatory decisions when regulation is required.¹⁶

¹⁰ Sharfman, *supra*, note 4 at 4.

¹¹ Jimmy Carter, Staggers Rail Act of 1980 Statement on Signing S. 1946 Into Law, (Oct. 14, 1980), Online by Gerhard Peters and John T. Woolley, THE AMERICAN PRESIDENCY PROJECT, <https://www.presidency.ucsb.edu/documents/staggers-rail-act-1980-statement-signing-s-1946-into-law>.

¹² 49 U.S.C. § 10101(2)

¹³ *Id.*

¹⁴ Sharfman, *supra*, note 4 at 2-4.

¹⁵ *Id.* at 7.

¹⁶ *CSX Transp. v. U.S.*, 867 F. 2d 1439 (D.C. Cir. 1988) (emphasis added); *see also Village of Ridgefield Park v. NY, Susqu. & Western Rail. Corp.*, 750 A. 2d 57 (N.J. 2000) (noting that a major purpose of the act is minimize federal regulatory control over rail service).

Implicit in allowing maximal competition is creating an environment in which profit and loss signals are undistorted by regulation, and profit opportunities draw new competitive entries into the market. Further, the Act itself explicitly forbids the STB from interfering in private contracting and rate setting between carriers and shippers (outside of situations where “market dominance” exists).¹⁷

Thus, instead of scrutinizing “growth” plans, the STB should focus on ensuring that its regulatory actions do not unnecessarily interfere with the industry's ability to operate efficiently and profitably. This is not to say that the STB has no role in helping firms to “grow” or otherwise be profitable. The deregulatory thrust of the Act, and the provisions noted above, suggest that the STB has an enduring obligation to determine when regulatory activity might interfere with new business models or technological innovations that could enable regulated entities to grow profitably.

For instance, the STB should evaluate how its regulations impact rail carriers' ability to price their services competitively. The Act states that rail carriers “may establish any rate for transportation or other service provided by the rail carrier.”¹⁸ Regulatory actions that hinder this freedom can directly affect profitability.

The STB could also evaluate how regulations might constrain carriers' ability to adapt their operations to changing market conditions,¹⁹ or how regulatory uncertainty or overly burdensome rules could discourage capital investments needed for long-term viability.²⁰ And, of course, technological innovation—as in every sector of the economy—will remain crucial to ensure the future profitability of the freight-rail industry.²¹ The STB should be doing everything within its remit to ensure that rail operators are empowered to experiment with new technologies that could increase consumer welfare dramatically.

For example, one study suggests that if crew sizes were to be reduced from two to one, carriers could save \$2.5 billion annually.²² Finding ways to promote automated trains could help make this a reality, and the STB may be in a position to determine where existing regulations make this kind of automation difficult or impracticable. By contrast, the recent reciprocal-switching rule²³ could have

¹⁷ Sharfman, *supra*, note 4 at 9.

¹⁸ 49 U.S.C. § 10701(c).

¹⁹ This is not an uncommon concern. For example, in the EU, the General Data Protection Regulation (GDPR) has been fairly controversial, with many observers noting that costs have risen for many firms without significant offsetting benefits for consumers. See, e.g., Andreas Streim & Isabelle Stroot, *After 5 Years: GDPR Only Receives the Grade “Sufficient”*, BITKOM (Oct. 5, 2023), <https://www.bitkom.org/EN/List-and-detailpages/Press/5-years-GDPR-receives-grade-sufficient>.

²⁰ See, e.g., Wolfgang Briglauer, Carlo Cambini, Klaus Gugler, & Volker Stocker, *Net Neutrality and High-Speed Broadband Networks: Evidence from OECD Countries*, 55 EUR. J. L. & ECON. 533 (2022) (Statistical analysis indicating that net-neutrality regulations slow broadband investment, as measured by the number of fiber connections deployed).

²¹ See, e.g., Christopher Mims, *How to Move More Goods Through America’s Clogged Infrastructure? Robot Trains*, WALL ST. J. (Oct. 9, 2021), <https://www.wsj.com/articles/how-to-move-more-goods-through-americas-clogged-infrastructure-robot-trains-11633812291>.

²² *Analysis of North American Freight Rail Single-Person Crews: Safety and Economics*, OLIVER WYMAN (2015) at 47.

²³ See, *STB Adopts Final Rule For Reciprocal Switching*, SURFACE TRANSPORTATION BOARD (Apr. 20, 2024), <https://www.stb.gov/news-communications/latest-news/pr-24-20>.

a negative effect on a carrier's profitability and capability to invest in long-range capital investment. The STB should reconsider this rule in light of this negative effect on long-term incentives.

Looking forward, intermodal competition is only expected to increase, particularly as technology improves in trucking (including the introduction of automated trucking).²⁴ This will continue to put pressure on rail freight as a shipping option, and put even more importance on the deregulatory aims of the Act.

One possible approach for the STB is to enact a “dynamic regulatory” regime, as outlined by Geoffrey A. Manne and Gus Hurwitz.²⁵ In essence, they advocate for regulators to construct information-feedback mechanisms between a regulator and a regulated industry.²⁶ Using these feedback mechanisms, the regulator serves as an important information gatherer who can then use the data on the performance of regulated entities to incrementally modify (improve) regulations.²⁷ This will necessarily require a flexible view of regulation; as information is collected, some rules will need to be attenuated, while in other cases, new extensions may be required. But ultimately, the goal is for the regulator to view itself as a dynamic entity that bases its behavior on empirical market realities.

Relevant to the spirit of this proceeding, STB could be well-positioned to, among other things, collect information on the profit challenges that carriers face. The STB could develop and utilize performance indicators that reflect the industry's long-term financial sustainability. These metrics should consider such factors as return on invested capital, operating-ratio improvements, and long-term investment capacity, which can then feed back into STB's review of its regulations and how they intersect with these factors.

Along these lines, another recommendation to improve the STB's regulatory decision-making would be to adopt formal requirements to conduct cost-benefit analysis in its rulemakings, similar to those used by executive agencies. Specifically, the STB could amend its procedures to: (1) require the inclusion of a cost-benefit analysis for proposed and final rules, including consideration of reasonable alternatives; (2) explicitly consider the cumulative impact of new rules in light of existing regulatory burdens; and (3) ensure the use of reliable, up-to-date data that reflects current market realities.

Such reforms would help ensure that board members have the information needed to make well-informed decisions, increase transparency, and reduce the likelihood of adopting rules that impose costs exceeding their benefits. By institutionalizing rigorous economic analysis, the STB can better

²⁴ See, e.g., McCall Macomber, *Truck Platooning Moving Freight into the Future*, ILLINOIS CENTER FOR TRANSPORTATION (Jul. 28, 2021), <https://ict.illinois.edu/news/newsletters/more-newsletters/august-2021/truck-platooning-moving-freight-into-the-future>.

²⁵ Justin (Gus) Hurwitz & Geoffrey A. Manne, *Pigou's Plumber (or Regulation as a Discovery Process)*, SSRN (Feb. 8, 2024), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4721112.

²⁶ *Id.* at 36-40.

²⁷ *Id.*

fulfill its statutory obligations to minimize unnecessary regulation, while promoting a healthy rail industry.

III. Conclusion

The STB's recent focus on industry growth plans represents a concerning departure from its mandated role under the Act. This approach not only misinterprets the Act's primary objective of minimizing regulation, but also risks interfering with the market forces that should guide the rail industry's development.

We urge the STB to reconsider its regulatory philosophy and realign its actions with the Act's intended purposes. The STB should refrain from scrutinizing or attempting to direct private firms' growth strategies, as such inquiries fall outside the board's regulatory purview and could lead to unintended consequences, potentially encouraging short-term thinking at the expense of long-term profitability.

Instead of focusing on raw volume growth, the STB should recognize that profitability and returns on invested capital are more meaningful indicators of industry health and economic efficiency. The board should also consider how its own activities might hinder the industry's ability to achieve profitable growth. Toward this end, the STB should prioritize investigating how existing regulations might interfere with rail carriers' ability to innovate, adapt to changing market conditions, and maintain long-term profitability. This includes evaluating the impact of regulations on pricing flexibility, operational efficiency, and technological advancement.

We recommend that the STB adopt a more dynamic regulatory approach by establishing feedback mechanisms to gather empirical data on industry performance, as well as using this information to refine its regulatory framework continuously. By shifting its focus from growth plans to regulatory impediments, the STB can better fulfill its role in fostering a competitive, efficient, and financially sustainable rail industry. This approach would not only align more closely with the Staggers Act's intent, but also better serve the long-term interests of rail carriers, shippers, and the broader economy.

We respectfully submit that the STB's energies would be better directed towards creating a regulatory environment that allows rail carriers to innovate, compete effectively, and achieve sustainable profitability. This, rather than a focus on predetermined growth metrics, is the surest path to a thriving and efficient rail transportation system in the United States. By embracing this approach, the STB can ensure that it remains true to its statutory mandate, while fostering an environment conducive to the long-term health and success of the rail industry.