

Public Interest Comment¹ on
The Surface Transportation Board's Notices of Proposed Rulemaking:

Docket No. EP 755, Final Offer Rate Review, and
Docket No. EP 756, Market Dominance Streamlined Approach

October 17, 2019

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October 17, 2019
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Introduction

The authors of this public interest comment were the members of a committee of experts in economics, regulatory policy, and freight transportation convened in 2014 by the National Research Council (NRC) of the National Academy of Sciences and instructed, in response to a Congressional mandate,⁹ to address and make recommendations on the regulation of railroad rates by the Surface Transportation Board (STB) as well as on a number of related issues. In our work we were supported by staff of the NRC's Transportation Research Board. We convened five times as a group, had numerous conference calls and email exchanges, and were briefed by representatives from the railroad industry, shipper groups, and government agencies, as well as academic and consulting organizations. Our 264-page report, entitled *Modernizing Freight Rail Regulation* (MFRR),¹⁰ was published in 2015.

¹ This comment reflects the views of its authors, not the views of any institutions with which they are affiliated. Affiliations are provided for identification purposes only. None of the authors have been compensated in any way for participation in writing or submitting this comment.

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⁹ Public Law 109-59, Section 9007.

¹⁰ National Academies of Sciences, Engineering, and Medicine 2015. *Modernizing Freight Rail Regulation*. Washington, DC: The National Academies Press. <https://doi.org/10.17226/21759>.

We are submitting this brief comment in both Docket No. EP 756, Market Dominance Streamlined Approach (MDSA), and Docket No. EP 755, Final Offer Rate Review (FORR), because these two proposed rules are highly complementary, responsive to the regulatory problems facing small shippers that we discussed in MFRR, and closely related to recommendations we made in MFRR. They are also closely related to some of the recommendations made in the report of the STB's Regulatory Reform Task Force (RRTF). We want to express our strong support for the general direction the STB is taking in these two proposals, and our recommendations below can properly be described as minor friendly amendments.

A Fundamental Problem

While these proposals could improve the current STB regulatory system, a fundamental problem with that system apparently cannot be solved without legislative change: the STB is required by statute to rely on estimates of shipment-specific variable costs,¹¹ which it derives from the Uniform Rail Costing System (URCS), in assessing whether market dominance is present. (The STB has also chosen to rely on URCS-derived figures in two of the three currently available tests for assessing the reasonability of individual rail rates.) In 1980 when the Staggers Act was passed, there was no alternative to the use of accounting figures as benchmarks to judge the reasonableness of particular rail rates, and the Act accordingly mandated the use of such figures.¹² The URCS cost allocation system was developed by the ICC in response to that mandate.

As MFRR documents in detail, however, URCS-based variable cost figures are inherently inaccurate and unreliable (MFRR 104-119). A large percentage of the costs a railroad incurs cannot be directly attributed to individual units of traffic. "Division of these cost items in any economically meaningful way among individual units or narrow segments of traffic is simply not possible." (MFRR 109) This problem is fundamental and cannot be solved by procedural or mechanical changes: "No cost allocation scheme can yield economically valid relationships for assessing a railroad's rate levels or market power" (MFRR 107). This insoluble problem is not a surprise to analysts familiar with the economics of public utilities and network industries.

Moreover, the railroad industry has changed dramatically since 1980, thanks in large measure to Staggers. Alternative, economically valid rate benchmarks are now available. Many rail rates are now competitively determined, and those rates can be used as benchmarks in rate review proceedings. We discussed this approach and its use in the text of our report (MFRR, Ch. 3) and two members of our committee provided a detailed demonstration of its workability

¹¹ 49 USC §10707(d)(1)(A)

¹² The Staggers Rail Act of 1980, §10705a(m)(1), required ICC to determine variable costs by using its Rail Form A costing method or to adopt an alternative method. Applicable cost accounting principles are provided in Title III, Section 301, §11162 of the Act.

(MFRR, Appendix B).¹³ There is no doubt that the use of competitive rate benchmarking would be both feasible and much more reliable than continued reliance on URCS-derived figures.

The two notices of proposed rulemaking on which we are commenting both assume no change in relevant legislation, however, and in what follows we make that same assumption. Thus we take as given the continued, unfortunate prerequisite that the ratio of revenue to URCS-determined variable cost must exceed 180% for a complainant's rate to be assessed more fully for market dominance.

Market Dominance Streamlined Approach (MDSA)

The proposed streamlined approach for assessing market dominance follows closely the recommendations of the RRTF. Except for its reliance on URCS, this proposal is economically sound, and it has the potential substantially to ease the burden on small shippers of initiating rate review proceedings, particularly when used in connection with FORR. We have three recommendations that would strengthen this approach:

1. The proposed rule sets a 50-page limit on reply and rebuttal submissions, but it imposes no time limits on any portion of the market dominance proceeding. Since delay is generally substantially more burdensome on complainants than on respondents, we would echo the RRTF and urge the STB to consider imposing time limits as elements of the MDSA. (Since the FORR imposes time limits at all stages, adding time limits to the MDSA would only matter when that approach is used in connection with alternative rate review procedures.) Indeed, it would be consistent with our report's recommendations to impose time limits on market dominance deliberations regardless of the rate review procedure ultimately to be employed if dominance is found (MFRR 196-197), and we urge the STB to consider doing so.
2. Under the proposed MDSA rule, if a shipper makes a prima facie case that it faces market dominance, the railroad involved has the ability to respond. Currently, evidence on product and geographic competition cannot be introduced in market dominance deliberations. This restriction was imposed by the STB in order to reduce the complexity and cost of market dominance deliberations.¹⁴ But excluding potentially relevant evidence always puts fairness and accuracy at risk. In MFRR we found that excessive delay should be directly addressed and that if this is done, as it would be either under MDSA with the addition of time limits or under FORR, "There should be no restrictions on the types of evidence - such as that pertaining to product and geographic competition - that can be introduced to assess market dominance" (MFRR 211). Antitrust agencies routinely consider product and geographic competition in contexts such as merger review, which proceed under legislated timelines (MFRR 122). We continue to recommend that the existing restrictions on types of evidence allowed in market dominance proceedings be removed in conjunction with adoption of deadlines to address the problem of

¹³ These two scholars have further refined that demonstration: Wesley W. Wilson and Frank A. Wolak, "Benchmark Regulation of Multiproduct Firms: An Application to the Rail Industry," National Bureau of Economic Research Working Paper No. 25268 (2018).

¹⁴ STB Ex Parte No. 627, December 10, 1998.

excessive delays. “Absence of product and geographic competition” could be incorporated as an additional element in the list of factors that would make a prima facie showing of market dominance.

3. The proposed list of factors that make a prima facie showing of market power includes the statutorily-required 180 percent R/VC ratio. Given that the majority of rail freight rates are now determined competitively, the rate benchmarking procedure outlined in MFRR (225-59) provides a superior indicator of whether a railroad may have market dominance and a useful check on inaccuracies introduced by URCS. “[T]he benchmark price could supplement the R/VC < 180 test to ensure that failure of this test is in fact due to a non-competitive price, rather than the methodological issues with the UCRS “variable cost” (VC) measure discussed in Wilson and Wolak (2016).”¹⁵ The two committee members who developed the rate benchmarking procedure explain in subsequent research how benchmarking could be used as a supplement to the R/VC test:

A railroad that sets a price that exceeds the benchmark level for its product and shipment characteristics could be required to identify the factors not included in X, the vector of observed product and shipment characteristics, that “explains” this high price. Conversely, the shipper can argue that these factors do not “explain” the high price charged.¹⁶

Therefore, we recommend that the STB employ a rate benchmarking process similar to the one we recommended in MFRR as an additional factor that would make a prima facie showing of market power.

Final Offer Rate Review (FORR)

In MFRR (122-134) we argued that the SAC test has at best a very weak economic rationale, and it has proven to be very burdensome and expensive in practice. The other current rate review standards rely on the URCS and are thus inherently unreliable. In addition, shippers do not seem to find them much more attractive than the SAC test.

In MFRR (211-214) we recommended using final offer arbitration as a rate review procedure, as has long been done in Canada. Like the RRTF, we further recommended that under that procedure evidence on market dominance be submitted at the same time as proposed rate levels, with strict time limits on each step of the procedure (MFRR 210-211). We strongly support the STB’s proposal to incorporate those features in the FORR. We have only three recommendations:

1. The STB asks if it should consider enabling complainants to use the FORR only if they also avail themselves of the MDSA. We see no rationale for this restriction. If complainants can make a showing of dominance in other ways without violating the

¹⁵ Wilson and Wolak, *supra* note 13, at 33. The reference is to Wesley W. Wilson and Frank A. Wolak, “Freight Rail Costing and Regulation: The Uniform Rail Costing System,” 49 *Review of Industrial Organization* 229 (2016).

¹⁶ *Id.*

FORR time limits, they should be permitted to do so. As noted above, limiting evidence risks inaccuracy and unfairness.

2. The proposed rule limits the size of the award that can be claimed under FORR. Since the two proposed rules most directly address issues raised by small shippers, it is reasonable to expect that small shippers will make the most use of them. But there is no conceptual reason why use of the FORR should be limited to small cases, and we did not propose such a limit in MFRR. The Notice requests views as to whether a second track should be established for larger cases under the FORR, possibly with more time allowed for each stage of the process. Consistent with our treatment of final offer arbitration in MFRR, we recommend that the STB establish such a second track, though we do not have a view on what sort of schedule might be appropriate for larger cases.
3. An interesting feature of the Canadian final offer arbitration system is that the independent arbitrators who are employed do not produce opinions justifying their decisions. Indeed, neither the final offers made nor the source of the one that was accepted is made public. This has the effect of not establishing precedents, which, it has been argued, both contributes to the flexibility of the process and increases the incentives of parties to settle before the arbitrator reaches a decision (MFRR 136-140).¹⁷ We recognize that the STB cannot transfer its authority to make market dominance or rate reasonability decisions to third-party arbitrators. Under the FORR the Board will have to make and announce these decisions. It may even be required to present the reasoning that led it to determine whether or not market dominance was present. But the nature of final offer arbitration, along with the number of relevant considerations specified in the proposed rule, would seem to enable the STB fully to discharge its obligations without going into detail on the reasons it chose one offer rather than the other. We recommend that the STB, as a matter of policy, provide in FORR decisions only enough information to make clear that it is not being arbitrary and capricious.

Conclusion

The approach STB proposes to take in the two Notices of Proposed Rulemaking on which we are commenting is generally consistent with our recommendations in MFRR. We strongly support a process that reduces the cost and complexity of market dominance proceedings by imposing time limits and using a simplified list of criteria to establish a prima facie case. We strongly support a final offer process to enhance parties' incentives to negotiate settlements. We have offered a few specific recommendations in the spirit of friendly amendments that would make the proposed procedures more consistent with sound economic principles.

¹⁷ T. Kochan and H. Katz. 1988. *Collective Bargaining and Industrial Relations: From Theory to Policy to Practice*, 2nd ed. Irwin, Homewood, Ill, pp. 279-284.