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February 29, 2000

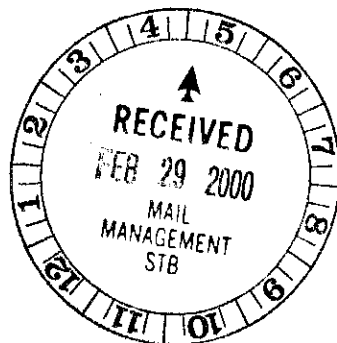
VIA HAND DELIVERY

The Honorable Vernon A. Williams
Secretary
The Surface Transportation Board
1925 K Street, N.W.
Washington, D.C. 20423-0001

UNITED STATES
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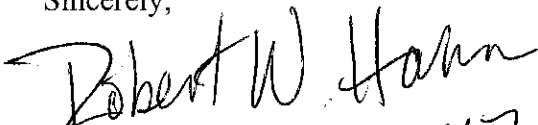
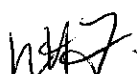
Re: Ex Parte No. 582 - Public Views on Major Rail Consolidations

Dear Secretary Williams:

Enclosed for filing in the above-captioned proceeding is the original and ten copies of my statement. Also enclosed is a diskette containing the statement in WordPerfect 6.1 format.

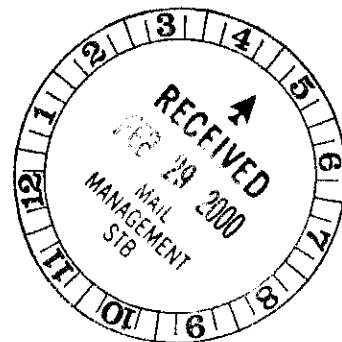
Please date-stamp the enclosed extra copy of the statement and return it to the messenger for my files.

Sincerely,


Robert W. Hahn, Ph.D. 

RWH/nhf

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**Statement of Robert W. Hahn
in Surface Transportation Board
Ex Parte 582**

I. Qualifications

I am Robert W. Hahn, Director of the AEI-Brookings Joint Center for Regulatory Studies, a Research Associate at Harvard University and a Resident Scholar at the American Enterprise Institute. I am also a special consultant to NERA.

I received my B.A. in Mathematical Economics and my M.A. in Economics from Brown University and my M.S. and Ph.D. from the California Institute of Technology. I have worked and published widely in the area of regulation over the last two decades and have done several assessments of the cost and benefits of regulation.

While serving as a senior staff economist to the President's Council of Economic Advisers, I was primarily responsible for writing chapters in the *Economic Report of the President* on the impact of airline deregulation and on the general impact of regulatory reform efforts.

Based on my background in regulation and regulatory economics, I was asked by BNSF to submit my comments on this proceeding.

II. Summary

In this proceeding, the Surface Transportation Board is considering changes in its current regulatory approach, including the possibility of declaring a "moratorium" on further combinations and consolidations in the rail industry, either long enough to enable some railroads to resolve their existing service problems or until the Board determines what the long-term structure of the national rail industry should be.

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The lessons of the past decades, however, show that the Board's existing policy is the correct one, one that is validated by experience in the rail industry and other sectors of the economy. In contrast, the alternative policies under discussion would lead toward a more centralized form of government planning that simply would not work or, at best, would lead to significant reductions in economic benefits as the gains of desirable industry restructuring are deferred or lost entirely.

III. Overview

The past few decades have seen a major change in the way economists -- and nations -- approach regulation. Economists of all political persuasions have concluded that regulation in structurally competitive industries is a poor substitute for the workings of the marketplace. Economists and regulators have learned that the "central planning" model does not work; it cannot allocate capital efficiently, it cannot force investment upon the capital markets, and it cannot reliably predict the future in a dynamic economy. Economists and regulators have also learned that when continued regulation is necessary, more refined regulatory tools are preferable to traditional regulatory approaches.

In response to this insight, a wide array of industries throughout the world have been either partially or fully deregulated over the past 25 years. In many industries, including rail, aviation, trucking, natural gas and telecommunications, increased competition has resulted in large benefits for consumers. Typically, these benefits have taken the form of lower prices, higher quality products, and the availability of wider ranges of services for consumers.

The use of more economically efficient regulatory tools has increased. In the environmental area, for example, we have learned the benefits of prescribing goals, rather

than forcing companies to invest in particular technologies, and of harnessing market forces. In areas like telecommunications, natural gas, electricity and, indeed, rail, we have learned the benefits of freeing many activities from intrusive government intervention, while maintaining regulation in more circumscribed areas.

While deregulation has generally been a great success, the actual industry structures that resulted often were a major surprise. Industries restructured themselves in unforeseen ways, developed innovative products and improved service options, and, in some instances, improved profitability. For example, few people predicted the massive expansion of telecommunications services and the convergence of the computer and telecommunications industries. These innovative and unforeseen market responses, made possible by the decision to free capital markets and industries to invest and innovate, have produced major societal benefits that helped fuel the expanding U.S. economy.

It is well known that the rail industry has been one of the success stories of the deregulatory effort in the United States. Commencing with the Staggers Act and supported by the efforts of the Interstate Commerce Commission and the Board, the industry responded vigorously to the lifting of the constraints under which it had labored, resulting in a rationalization of the national rail system, increased investment and productivity, an improved safety record, and decreased average rates.

At the same time, the Board carefully steered a path between over-regulation and under-regulation. The Board has ensured that consolidations do not eliminate the benefits of competition for consumers or result in the loss of essential services for shippers. The Board has responded when service problems have arisen from prior consolidations. In reviewing particular transactions, the Board has carefully examined operating plans, competitive issues,

and capital issues. But, the Board has refrained from attempting to dictate the structure of the industry.

Despite this sustained record of success, in response to the proposed combination of BNSF and CN, some have suggested that the Board should delay its consideration of any additional rail consolidation until (i) existing service problems on other rails are resolved, or (ii) the future of the rail industry can be determined. This fundamental change from the Board's existing strategy would be a mistake.

As the Board and interested parties consider these issues, we should think carefully about what the appropriate role for government and the appropriate role for the marketplace should be. I think that we can draw four clear lessons.

First, the market plays a vital role in identifying efficiencies that improve productivity and provide better services to producers and consumers. In a free-market system, entrepreneurs compete by putting their money at risk. They are, therefore, as a general matter, in a better position than the government to try to identify ways of making industry more efficient and effective, including how best to restructure.

Second, regulators should not postpone today's beneficial outcomes because some competitors are having problems of their own. The marketplace does not allow "time-outs", and consumers will lose when innovation and productivity increases are deferred or denied by regulators. The bottom line is that regulators should not insulate competitors from competition.

Third, regulators should not assume a central planning role. Efforts to prescribe the shape of industries have failed, both because regulators and governments cannot force capital

to follow regulatory decisions and, equally important, because of the inherent limits on our abilities to foresee the innovations and demands of the future.

Fourth, while experience with deregulation in the U.S. and throughout the world has generally been beneficial for consumers, economists agree that government can play an important role in helping to assure that ongoing changes in industry structure continue to benefit consumers. Particularly in the area of competition policy, economists generally agree that there should be some government entities that review potential consolidations or mergers that could be anticompetitive. Similarly, it is important for regulators to determine whether potential consolidations will create new efficiencies and benefits, or result in additional costs for consumers and the industry. Indeed, one of the important roles of the Board is to review transactions involving rail restructuring to determine whether the transactions are in the public interest.

The Board's current regulatory approach fits in well with these lessons we have learned about the appropriate role of the government and the marketplace. However, some of the regulatory options raised in this proceeding would clearly constitute a step backward, toward a regulatory philosophy that created the very barriers to capital investment, rationalization, and innovation that led to the Staggers Act.

IV. Positive Experience with Deregulation in Many Industries

As I discussed above, a relatively broad consensus has emerged in the past three decades about new principles of regulation. Policymakers generally agree, for example, that regulation aimed at controlling prices or entry will lead to inefficiencies in industries where competition can be sustained. In such industries, competition is viewed as a positive dynamic force that will encourage innovation and promote growth.

The experience of a number of industries following deregulation illustrates this point. For example, the fierce competition that followed deregulation in the airline industry resulted in a decline in the cost of air travel, lower ticket prices, an increase in the frequency of flights, and the development of “independent” or “low cost” airlines, such as Southwest. Deregulation of the trucking industry led to a significant decline in real average shipping rates and faster and more reliable service. Motor carriers’ empty travel miles were also substantially reduced following deregulation, and, in an advance that could not have been foreseen at the time, new computer technology is resulting in new efficiencies. Deregulation in the natural gas industry led to a reduction in rates for both residential and retail consumers, improvements in the quality and reliability of service, and more efficient use of pipeline capacity during peak and off-peak periods. Importantly, most customers have benefitted. In the area of telecommunications, consumers have benefitted from the dramatic reductions in long distance rates as well as the increase in the variety and availability of telephone service options.

My understanding is that following the passage of the Staggers Act, average rates fell, productivity improved, investment in the industry increased, average transit time was reduced, and firm profitability increased. The regulatory reform resulting from the Staggers Act was critical to the health of the rail industry and the entire U.S. economy.

V. Importance of Efficient Rail Network to U.S. Competitiveness

Regulatory policy now has implications for both domestic and international competitiveness. U.S. industry is facing increased competition in the global marketplace. The decline in international transportation and communication costs has made it easier for firms to relocate where production costs are lower. By lowering the cost and expanding the

geographic range of shipping, an efficient transportation network makes it more attractive for producers to remain in or relocate to the United States. In addition, better transportation networks can help facilitate trade. For example, an expanded railroad network encourages trade by facilitating the flow of goods and services both nationally and internationally. There is widespread agreement among economists that barriers to trade hurt consumers and that freer trade benefits consumers. U.S. industrial producers must have an efficient U.S. transportation network if they are to remain competitive in the face of increasing global competition and take full advantage of the opportunities created by the North American Free Trade Agreement. The rail network is a key component of the U.S. transportation network.

U.S. industry has already benefitted from the improved efficiency of the U.S. rail network. Lower transportation costs have helped domestic producers who ship heavy goods compete with overseas companies. Improved service and integrated network scheduling have also helped producers of time-sensitive products. However, the demands of the economy, including the need to respond to freer trade, can only be met through new investment and innovation. The best way to ensure that U.S. consumers and U.S. industry receive the benefits of freer trade is to assure vital competition and avoid over-regulation.

VI. The Lessons of Deregulation for the Railroad Industry

The deregulatory experience of the past few decades offers several important lessons as the Board contemplates what changes, if any, are required in its regulatory model. These lessons suggest that the Board should maintain its proven course.

First, Ex Parte 582 raises, in part, the question of whether, as a generic matter, further consolidation of the U.S. rail industry is in the public interest. Experience teaches us that the Board, looking at a case-specific and fully developed record, can determine whether

any specific transaction is in the public interest. However, no one can predict the final or optimal structure of industry, in large part because, as noted above, regulators cannot force entrepreneurs and capital markets to pursue strategies or make investments that they do not believe will produce results. Equally fundamental, it has proved impossible for central planners to forecast accurately how industries should be structured to meet the requirements of the economy and the demands of consumers. They simply lack the necessary information.

Our experience also has taught that comprehensive regulation of prices and quantity, and creating regulatory barriers to entry leads to a serious misallocation of resources. An extreme case in point is the Soviet Union's attempt at a centralized economy. There are, however, many examples, including U.S. examples, of more limited attempts by the government to regulate prices and establish barriers to entry that resulted in large inefficiencies. For example, in the 1970's, the government's regulation of the interstate natural gas market proved disastrous. While the intrastate markets had surpluses of natural gas, industries, hospitals, and schools that relied on interstate gas were forced to close as service curtailments swept the country. The legislative efforts to solve the service curtailments resulted in further problems until complete deregulation of well head gas prices in the interstate market was finally adopted. Regulatory fixes often are not the best answers to past regulatory problems.

As the Board considers whether to return to a more centralized approach to planning, we should apply the lessons we have learned about heavy handed regulation in industries like the natural gas industry. We should also remember that the pre-Staggers Act rail industry suffered, in large part, from the consequences of government delincation of business

structures that the market could not support. For example, the government's large role in establishing equalized rates and routes constrained the railroads ability to use their capacity efficiently and to tailor their services to meet individual shipper's production needs.

Second, Ex Parte 582 raises the question of whether the Board should establish a "moratorium" on further consolidations, at least until the well-publicized problems on some rail systems are resolved. Regulators cannot, however, determine when capital markets will find opportunities for efficiency gains – these opportunities come and go. For example, during the period of regulatory delay, investors may decide to reallocate their capital to investments with higher expected returns or lower risks. As a result, efficiency gains that are deferred may be lost forever – and consumers could lose forever the benefits of the unrealized gains.

This is not to say that the Board should not be aware of the current service difficulties. However, the Board must carefully distinguish between two very different problems. As a matter of economic policy, the Board should encourage competition; it should not allow any competitor to delay the introduction of increased efficiency and competition while that competitor resolves its current problems. Similarly, the Board should review, as it can only in a case-specific proceeding, whether the new consolidation will create side effects that will export problems to competitors.

Third, the Board has a vital role to play in maintaining quality of service, encouraging capital investment, and protecting competition. However, stable, long-term regulatory policy is essential to encourage the investments required to maintain service, to improve productivity, and to benefit consumers. Given the recognized and inherent limits to central planning, the Board should protect and further its identified public policy objectives

by reviewing the specific transactions that are brought before it and rigorously measuring those transactions against its regulatory goals.

VII. Conclusion

Clearly, the STB has an important role to play in the railroad industry – in protecting competition, ensuring quality of service, and helping the industry attract the capital it needs. Just as with other sectors of the economy, the market is best suited to determine the appropriate evolution of the railroad industry, subject to the checks imposed by the government. The government should evaluate changes in the market on a case by case basis, without attempting to predict the ultimate structure of the rail industry. Experience has taught us that it is virtually impossible to predict the evolving structure of a deregulated industry, that the government cannot efficiently run capital markets, and that there are significant costs to having the government intervene in capital markets in a heavy handed manner. Specifically, the government should not delay making decisions on real-world transactions. Such delays are more likely to harm consumers and producers, and hinder innovation by deferring the benefits of “good” consolidations.

In short, the rail policy since the Staggers Act and the Board’s implementation of that rail policy have been a general success; it is a sensible policy, based on both the impact on the rail industry and the general economy. Therefore, I encourage the Board to stay the course, adhering to a flexible regulatory policy that recognizes the lessons of the past decades of experience on the limits of regulation and successes of deregulation; a policy that correctly identifies the critical role the Board plays in reviewing the actual transactions before it; and a policy that recognizes the benefits of a stable, regulatory environment in

attracting the capital necessary to invest in infrastructure, improve productivity, and enhance the quality of service to all rail customers.