



ARC

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As we discussed in previous newsletters, Christiansen Associates released and presented to the STB earlier this month their study on rail competition. We have carefully examined the study beyond the initial announcements, with a specific attention being paid to the issue of Final Offer Arbitration, a key provision that, if enacted, will bring significant relief to captive shippers. The following is commentary by Michael Snovitch, Executive Director of ARC.

Final Offer Arbitration and the Christensen Study

After reviewing the Christensen study and watching the consultants' presentation before the STB, it seems that Final Offer Arbitration holds the most promise for shippers to gain a level field in negotiating rates and service with the railroads. This is especially true for captive shippers.

Why draw this conclusion? First, let's look at the questions and thoughts that the STB members brought out during the presentation. One member of the Board clearly had technical understanding of the study and its findings concerning the captive shippers. However, the other members did not seem to have the same depth of understanding. Several points were voiced by the STB, which were of concern to us. Those included:

- A thought that railroads are very efficient, therefore no competition exists.
- A question about the difference between total cost and marginal cost.

Statements and questions of this level impart a perception by many shippers that fundamental understanding of complex economic study of railroads and their market power must be a requirement for future members of the Board. It is this potential lack of understanding that causes concern among shippers when they look to the STB for execution of its regulatory duty.

A quick review of the Christensen study seems to indicate that it is a good, thorough study into the present state of the railroad industry. The authors did not say if there was "abuse of market power" or "fair pricing", but rather suggested such determination be a policy issue. This is unfortunate, since there are specific economic terms, which define monopolies and some of their characteristics. In fact, the executive summary specifically points out that "while recognizing that differential pricing and the exercise of local market power is necessary to achieve financial viability, in both our qualitative and quantitative research, we did find concerns about shipper captivity and railroad performance".

The study largely confirmed the results of the 2001 and 2006 GAO reports. Shippers who have no carrier options pay considerably more than those with options. There is also some evidence that those with no options have poorer service. Railroads are generally exercising increased market power – the study specifically points out that "the exercise of market power appears to have increased in the freight railroad industry over the last twenty years." The study also concludes that railroads revenues "noticeably" exceed industry costs. This is a clear sign of market power and possible "abuse of power". The study also questioned the revenue/variable cost indicator as a sign of whether a shipper was captive. The genesis of the 180% value also was questioned. I believe anyone who worked in transportation studies had the same "gut feel" about the revenue/variable indicator.

The report spent considerable time discussing the following table:

	Reciprocal Switching	Bottleneck Rates	Terminal Agreements	Trackage Rights
Economies of Density	Potential gains	Gains unlikely	Potential gains	Potential gains
Length-of-Haul Economies	Small loss	Potentially large loss	No gain to small gain	No gain to small gain
Vertical Economies	Small loss	Potentially large loss	Small loss	Potentially large loss
Investment Incentives	Small effect	Potentially large effect	Small effect	Potentially large effect
Railroad Profitability	Small effect	Potentially large effect	Small effect	Potentially large effect
Coordination Costs	Small to moderate	Small to moderate	Small to moderate	Potentially large
Competitive Response	Most likely	Least likely	Most likely	Somewhat likely
Shipper Gains	Most likely	Least likely	Most likely	Somewhat likely

Christensen states in chapter 22 that “incremental policies such as reciprocal switching and terminal agreements have a lower potential of leading to adverse changes to industry structure, costs, and operations, and additionally have greater likelihood of resolving some of the shipper concerns via competitive market responses”. Any drastic changes are likely to have adverse impacts on the railroads, shippers, or both.

During the presentation, the Christensen consultants voluntarily brought up the Final Offer Arbitration as a possible way to improve the functioning of private matters without imposing additional regulatory burdens. “To the extent that the threat or possibility of final-offer arbitration encourages parties to negotiate and reach voluntary agreement or resolve disputes, as suggested by a number of stakeholders we interviewed, it would improve the functioning of private matters without imposing additional regulatory matters.” Their one major caveat was that the arbitrators had expertise in the railroad industry and its economics so that decisions would not contradict those economic realities. Of course, this is the same issue both railroads and shippers face at the STB. Decision makers, whether at the STB or the arbitrators, must be competent and capable to render fair and equitable decisions. The FOA has the advantage that arbitrators are chosen by the railroad and the shipper in dispute rather than appointed through the political process for political reasons.

The value of Final Offer Arbitration has never been greater in resolving differences between the railroads and shippers. The railroads appear, in certain markets, to have curtailed competing for market share concentrating on revenue levels instead. Traditional transportation thought centers around the premise that two or more railroads in a market will compete for market share. In today’s reality, as the railroads have completed their mergers down to the Big 4 controlling over 94% of shipments and now choosing not to compete at in certain markets, it becomes ever so more important that shippers and carriers have a way to arrive at commercial solutions on a level playing field – and the answer is final offer arbitration.

Lastly, the Christensen study confirms that political pressure does have an effect on the way railroads behave. Market dominant railroads appear to react to political pressure. “Our results with respect to a single railroad serving the origin county indicate that rail rates are commonly higher than they would be in the presence of even very limited railroad competition. Railroads appear to exercise some degree of local market power where possible, but are tempered by the prospect that large markups may elicit regulatory attention if not direct intervention. That is, monopoly railroads may effectively cede some market power to avoid regulatory scrutiny.”

The outlook for passage of meaningful rail competition legislation in the 111th Congress has never looked brighter. Chairman Oberstar will continue to lead the House Transportation and Infrastructure Committee and Senator Rockefeller takes over the gavel at the Senate Commerce, Science and Transportation Committee. Through our efforts in the last Congress with the passage of eight major amendments in legislation covering energy, appropriations, agriculture and several others, there will be a series of studies to address various aspects of the railroad issues and captivity.