

## Utility Deregulation: No Model for Railroads

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### Summary

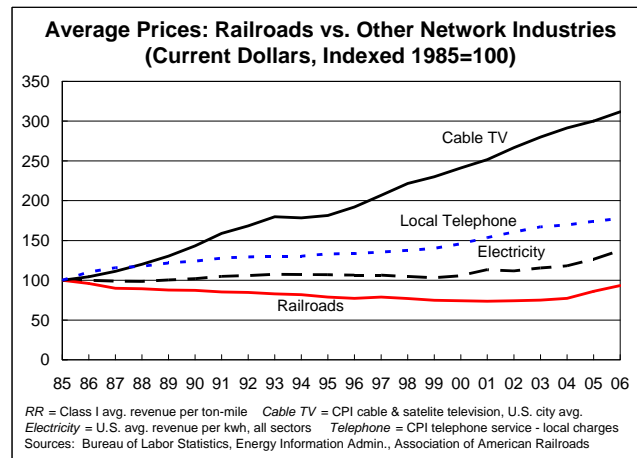
The “open access” regulations that have been implemented in the electricity, natural gas, and telecommunications industries are not appropriate models for railroads. Open access in these industries is meant to produce the efficient, competitive structure that is *already* in place for railroads. Moreover, the implementation of open access in these other industries has often been chaotic, associated with unending legal conflicts, tangled regulations, bankruptcies, reduced investments, and myriad other serious problems. These problems underline the importance of having a coherent, market-oriented regulatory system that provides, among other things, proper economic incentives for continued infrastructure investments.

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### Railroads Have Already Achieved the Objectives Sought for Utilities

- ▶ The primary goal of “open access” in electricity, natural gas, and telecommunications has been to inject competition where it is lacking. There is no shortage of competition for U.S. freight railroads, who almost always face a variety of competitive constraints that rail customers — including those served by only one railroad — can use to their advantage in negotiations over price and service.
- ▶ Where a railroad does not face effective competition and is found to have market dominance or to have engaged in anti-competitive behavior, the Surface Transportation Board (STB) can set maximum rates or take certain other actions. Under STB guidelines, railroads that do not face effective competition for a particular movement can charge no more than what an efficient competitor would charge. This ensures that the benefits of competition are made available to all rail shippers because it seeks to replicate how a competitive industry would price its services.
- ▶ Open access in other network industries means that infrastructure owners become, in essence, common carriers. For example, owners of electricity transmission lines are now generally required to transmit electricity generated by any producer. Likewise, cable companies that offer Internet access have come under pressure to offer transmission access to competing Internet service providers (ISPs). In these kinds of cases, the other industries are being asked to do what railroads have been doing for decades. In the examples given, the various electricity generators and the various ISPs are comparable to competing coal mines on a railroad's line. As a common carrier, a railroad cannot, by law, transport the coal from one mine and refuse to transport the coal from the other. The railroad has to carry both, if both request it on reasonable terms. Thus, open access in the other industries takes them to where railroads already are.

- ▶ The traditional monopoly structure of utilities promoted inefficiencies and protected high cost producers. A major goal of deregulation has been to squeeze inefficient costs out of them. Railroads have faced pervasive competition for decades and must continually strive to eliminate inefficiencies. Especially since the Staggers Rail Act of 1980 partially deregulated railroads, they have made massive productivity gains and passed them through to rail customers in the form of sharply lower rates. Average rail rates are lower today than they were in 1985, in contrast to prices in the other industries.



- ▶ Unlike many firms in the other industries, railroads do not have essentially guaranteed customer bases and financial returns. Railroads exist only where the competitive market supports them, and multiple railroads serve a particular market only where demand justifies it. Trying to mandate more competition than the marketplace will support would reduce competition, not enhance it, because it would prevent railroads from covering the full cost of providing service across their systems.
- ▶ In the other industries, monopoly control over certain facilities gave vertically-integrated firms the ability to favor their own products over competitors. For example, a vertically-integrated electric utility could use its ownership and control of transmission lines to favor electricity produced by its own generating plants, at the expense of electricity generated by others, even if the other generators were more efficient. The situation is vastly different for railroads. In contrast to firms in other industries, railroads that control a bottleneck have no incentive for “self dealing — they do not produce or own what they are transporting.

### Cost Recovery Must Be Allowed

- ▶ Firms must be able to recover the full costs of efficient operations, including a competitive return on capital — a critical point recognized by regulators of other industries, courts, and the other industries themselves. For example, a representative of the electric utility industry stated that “I cannot overemphasize the need for FERC to establish and put into effect a durable regulatory framework that says if I prudently invest a dollar in transmission infrastructure, that I will be able to fully recover that dollar, along with my cost of capital, through electricity rates. Such a framework is essential to raising the substantial and nearly unprecedented amount of capital necessary to construct needed, cost-effective transmission facilities.”<sup>1</sup> In telecom, courts have decreed that regulators’ attempts to force “unbundling” at non-compensatory rates are unlawful. Proponents of railroad reregulation not only want railroads to have to carry

<sup>1</sup> Statement on behalf of the Edison Electric Institute by Alan J. Fohrer, CEO, Southern California Edison, to the Federal Energy Regulatory Commission, April 22, 2005.

their traffic (railroads already have to) — they also want railroads to carry the traffic at non-compensatory rates. This goes far beyond what has been expected or permitted elsewhere.

- ▶ Without the ability to cover total costs, railroads would be unable to adequately maintain their existing infrastructure and equipment, much less invest in the substantial new capacity needed to meet our growing freight transportation demands. The result would be deterioration and/or shrinkage of the national rail system that would severely damage our domestic economy and undercut our international competitiveness.
- ▶ Other industries involve fungible products (*e.g.*, electric current from any producer can be delivered to any customer) or products that can readily be routed to specific customers using automated equipment (*e.g.*, electronic signals for telecommunications). By contrast, railroads must move specific commodities in specific railcars to specific locations. The distributional complexities for railroads are orders of magnitude higher than for other network industries.
- ▶ Railroads have a distinctive cost and demand structure, including a market-driven mix of traffic with widely varying dependence on a diverse spectrum of rail services. With such a mix, railroads require differential pricing to survive. The same is not necessarily true of firms in other industries.
- ▶ Regulators and legislators in many states have done something for electric utilities that is certainly not being considered for railroads by proponents of railroad reregulation. If enhanced access in the electric utility industry results in assets becoming underutilized or unnecessary — *i.e.*, “stranded” — the utility is allowed to recover from ratepayers its investments in the assets.
- ▶ The implementation of open access and other reforms in the other industries has often been chaotic, characterized by countless protracted and hugely expensive lawsuits and adversarial proceedings over terms of access and other issues before regulatory tribunals; bankruptcies and reorganizations; reduced investments; micromanagement by regulatory bodies; inconsistent and unclear regulations; and in extreme cases — for example, in California a few years ago — billions of dollars of extra costs to consumers. These serious problems underscore the importance of having a clear, market-based regulatory system that recognizes the necessity of full cost recovery and creates the proper economic incentives for network firms to continue to make adequate investments in their infrastructure.