

Utility Deregulation: No Model for Railroads

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. In addition, the implementation of open access in the other industries has often been associated with unending legal conflicts, tangled regulations, bankruptcies, reduced investments, and myriad other serious problems. These problems underscore the importance of having a coherent, market-oriented regulatory system that provides, among other things, proper economic incentives for continued infrastructure investments.

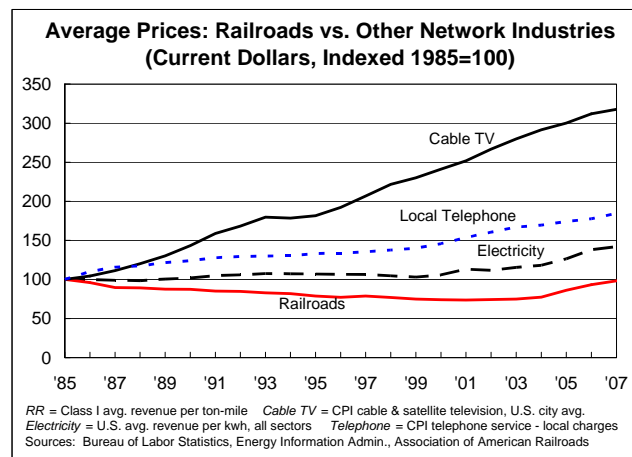
Railroads Have Already Achieved the Objectives Sought for Other Industries

The primary goal of “open access” in electricity, natural gas, and telecommunications has been to inject competition where it was lacking. There is no shortage of competition for U.S. freight railroads, who almost always face a variety of competitive constraints — including in cases where a shipper is served by only one railroad.

Indeed, open access in other network industries means that infrastructure owners are being asked to do what railroads have been doing for decades:

- A major goal of open access in the other industries has been to squeeze out inefficiencies.

But railroads have faced pervasive competition for decades. Especially since passage of the Staggers Rail Act of 1980 (which partially deregulated the rail industry), railroads have become far more efficient, passing their huge productivity gains to their customers through sharply lower rates. Average rail rates in 2007 were lower than they were in 1985 — in contrast to prices in the other network industries (see chart).



- Open access in other network industries means that infrastructure owners become, in essence, common carriers. For example, electric transmission lines now generally must carry electricity generated by any power company. Likewise, cable companies that offer

Internet access have come under pressure to offer access to competing Internet service providers (ISPs). In these examples, the electricity generators and the ISPs are comparable to competing coal mines on a railroad's line. As a common carrier, a railroad cannot, by law, transport one mine's coal and refuse to transport the other's. 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.

- In the other industries, monopoly control over certain facilities allowed firms to favor their own products over competitors. For example, an electric utility could use its ownership and control of transmission lines to favor its own electricity at the expense of electricity generated by others. The situation is vastly different for railroads. Railroads have no similar incentive, since they do not produce or own what they transport.
- Unlike many firms in the other industries, railroads do not have virtually guaranteed customer bases and financial returns. Railroads exist only where the competitive market supports them.

Cost Recovery Must Be Allowed

Firms must be able to recover the full costs of efficient operations, including a competitive return on capital. Other industries know this. For example, an electric utility representative stated that “I cannot overemphasize the need for ... 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.”¹ In telecom, courts have decreed that regulators' attempts to force “unbundling” at non-compensatory rates are unlawful.

Some rail critics who favor re-regulating railroads, though, not only want railroads to have to carry their traffic (railroads already have to), but also want railroads to carry the traffic at non-compensatory rates. This goes far beyond what has been expected or permitted regarding other industries.

Without the ability to cover their costs, railroads would be unable to adequately maintain their existing track and equipment, much less invest in the substantial new capacity needed to meet our growing freight transportation needs. Not allowing total cost recovery would lead to the deterioration and/or shrinkage of our rail network — an outcome completely at odds with our global competitiveness and economic health.

Other Differences Between Railroads and Other Industries

- 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.

¹ 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.

- 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.
- Railroads have a distinctive cost and demand structure and a mix of customers that differ widely in their willingness to pay for rail service. With such a mix, railroads must charging relatively higher rates to customers who have fewer competitive options than to customers with more competitive options. This is the most economically-efficient way for railroads to cover their costs. The same is not necessarily true of firms in other industries.
- The implementation of open access and other reforms in the other industries has often been chaotic, characterized by 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 need for full cost recovery and creates the proper economic incentives for firms to continue to make adequate investments in their networks.