Insight

Reciprocal Switching: Re-regulation at the STB?

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Much of the talk surrounding regulatory policy in the Trump Administration era has centered around deregulation. At one agency, however, a significant proposal may soon be up for debate that could lead to a different result: re-regulation.

The Surface Transportation Board (STB), the independent federal agency that regulates the economic operations of freight railroads, will consider a proposal in the near term that would be a notable departure from the industry's deregulation of the 1970s and 80s. Those reforms, as history shows, are a big reason why consumers, railroads, and shippers are unquestionably better off today than 40 years ago.

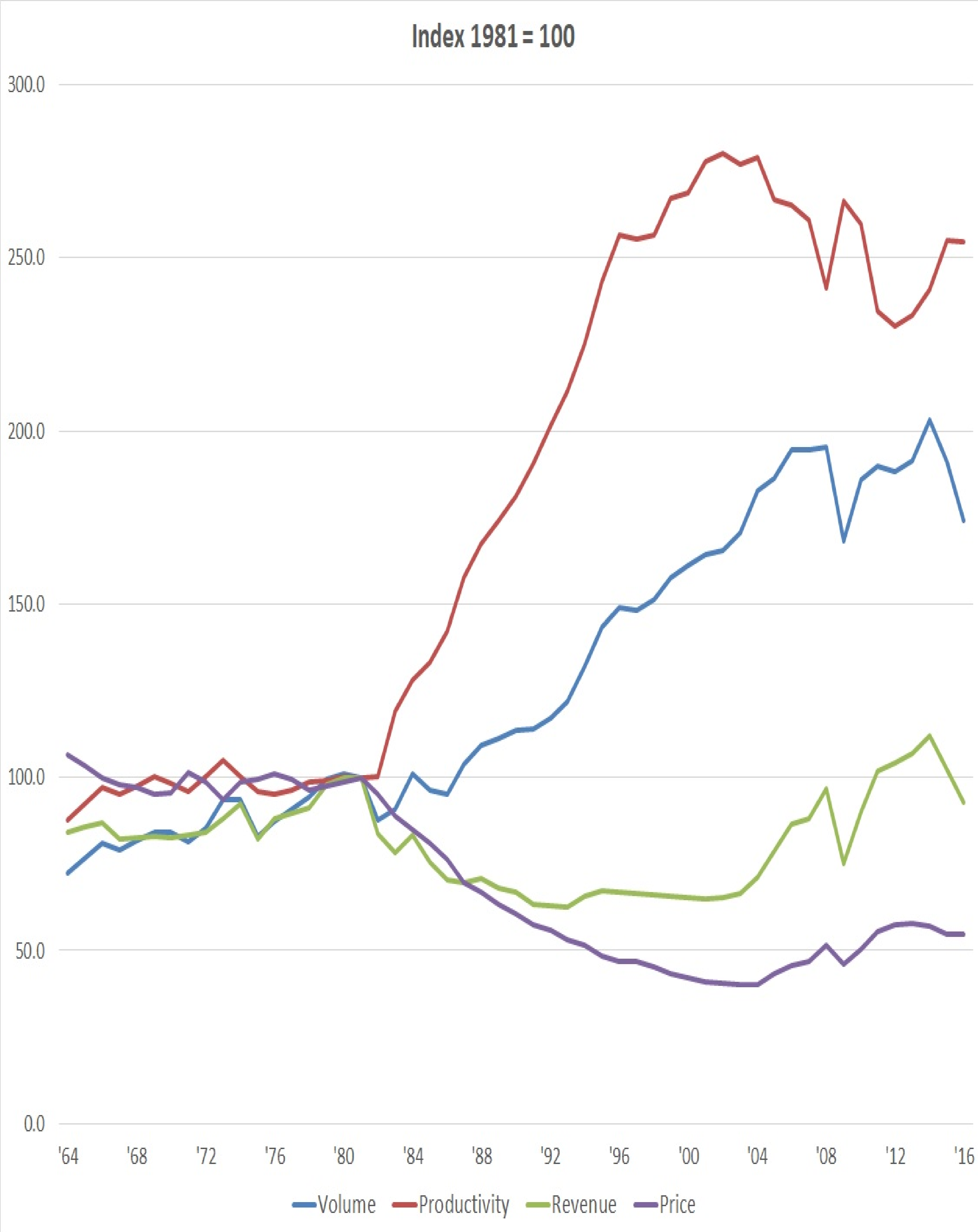
This week, the Senate Committee on Commerce, Science, and Transportation will consider the nomination of two potential STB commissioners. Among the issues likely to be raised during the hearing are the right level of regulation for the freight rail industry and how rate regulation affects the ability of rail carriers to invest in their networks.

HISTORY OF RAILROAD REGULATION

Congress established the STB in 1996 to replace the Interstate Commerce Commission (ICC), and its regulation of freight rail. The ICC had authority to control the entry and exit of firms, prescribe certain route coverage, review rates, review mergers and consolidations, and prohibit unfair competitive practices. By the 1950s and 60s, the ICC's broad authority to regulate virtually all aspects of the freight rail industry – which stemmed from the robber baron days of the late 1800s – had taken its toll on the industry's viability.

The vast improvement of highways and the creation of interstate expressways meant that railroads now had to compete with motor carriers for the movement of freight. Because of their inability to set lower rates as the market dictated, exit unprofitable routes, and consolidate efficiently, railroads were unable to respond to this new competition. As railroads declared bankruptcy, instead of nationalization, Congress enacted a series of reforms that culminated in the Staggers Rail Act of 1980. This legislation did not fully deregulate the freight rail market, but largely freed railroads to negotiate contracts with shippers and set rates as the market would allow. It is important to note that Congress maintained the ICC's (and now the STB's) authorization to address claims from shippers to ensure that railroads with insufficient competition did not charge unreasonably high rates. To this day, the STB directly regulates the rates of many commodities and maintains broad authority over the financial health, or "revenue adequacy," of individual carriers.

Within a few years of the Staggers Act – as railroads were able to merge, get rid of unprofitable routes, and negotiate rates – the industry began to improve. As the chart below shows, productivity and volume increased, while rates decreased. Though revenue initially fell, it steadied by the mid-1990s. Dollar values are adjusted for inflation.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Volume
Productivity
Revenue
Price

Source: Association of American Railroads

RECIPROCAL SWITCHING

As the chart above shows, prices paid by shippers decreased steadily through 2003, at which point prices began to rise moderately. Prices for 2016, though higher than the lowest rates on the chart, are still 45 percent lower than in 1981, the first full year of operation under the partial deregulatory structure. Regardless, this increase over the last decade and a half has led shippers to look for regulatory intervention by the STB to help lower prices.

One such intervention relates to reciprocal switching. In some cases, a given shipper's facility is served by only one railroad, but another railroad can more efficiently move its goods. Under reciprocal switching, the shipper can use the second railroad further away. For this to happen, the second railroad pays the nearer railroad to ship the goods until it reaches the second, and at that point the cars are transferred. Reciprocal switching occurs naturally in the market and allows shippers to lower their costs. The STB also has authority to require it, though has yet to do so since adopting its applicable regulations in 1985. Because of this, a group of shippers petitioned the STB in 2011 to propose a rule that would make it easier to impose reciprocal shipping in cases meeting certain criteria.

The three-member STB voted two to one to act in 2016, granting the petition in part, and proposing a rule that would lead to increased "forced switching" or STB-mandated reciprocal switching. The proposal differed noticeably, however, from the shippers' initial petition. Rather than establish specific criteria, it applied more nebulous language that would be adjudicated on a case by case basis. As STB phrased it, the proposed rule would change "the Board's reciprocal switching rules to promote further use and availability of reciprocal switching." The existing standard requires shippers to demonstrate that a railroad has engaged in an uncompetitive act. The 2016 proposal eased the requirements on shippers in such cases, requiring them to show either that the switching would be practicable and in the public interest, or that it was necessary to provide competitive rail service.

Since the proposal, the STB has taken no further action, largely due to the Board's membership shrinking to two active members. If the nominees before the Senate Commerce Committee this week are confirmed, and a Democrat is confirmed this year to bring the Board to full membership, it is expected that the Board will revisit the 2016 proposal.

ABSENT REGULATORY ANALYSIS

The STB is an independent agency and as such is not required to perform a cost/benefit analysis under any of the executive orders that require them. Still, it is notable that the STB – an agency created out of a substantial deregulatory effort – is considering a substantial regulatory change without a reliable analysis of the change's effect. In its decision to issue a proposed rule, the Board said that because decisions under the rule would occur on a case-by-case basis, impact analysis would be exceedingly difficult.

Governmental estimates of how much current freight rail traffic the rule would cover were limited to that of the Department of Transportation (which looked only at the largest railroads) and the Department of Agriculture (which looked only at grain and oilseed traffic). However, these analyses reviewed the initial proposal put forth by the shippers in 2011, not the 2016 proposal. Neither agency has yet to offer any analysis of the latest version.

For their part, the freight rail industry and shippers offered their own impact analyses during proceedings related to the original petition. However, neither has offered a meaningful analysis of the effect of the 2016 proposal. The main industry group, the Association of American Railroads, argues in its comments that the 2016 proposal presents too much uncertainty to estimate. The main shipper interests, the Alliance for Rail Competition and the Rail Customer Coalition, have thus far not offered an analysis.

It will be worth watching whether new leadership and membership at the STB opts to analyze the potential impacts of the change before acting on the proposal. One sign that the Board may choose this path is that Chairman Ann D. Begeman was the lone dissenting vote in the decision to propose the 2016 rule. In her dissent, she specifically identified a lack of analysis as a reason for opposition, wondering how the Board could "provide fair and consistent switching judgments on a case-by-case basis without creating complexity and cost impacts on the one hand, and not introducing more unpredictability to the rail network on the other."

CONCLUSION

The deregulation of rate setting in the freight rail industry has been beneficial to the industry, shippers, and consumers as rates have dropped and volumes have increased. Justification for the STB's 2016 reciprocal switching proposal seems to stem from the fact that the agency has not forced reciprocal switching on railroads since 1985. This fact alone does not necessarily warrant regulatory action. Accordingly, the STB should conduct a thorough analysis of its 2016 proposal before it acts to restrict the market by making it easier for the Board to impose switching requirements on freight railroads.