Railsroads Face Fierce Competition

KEY TAKEAWAY

Railroads face competition from other railroads, other modes of transportation, product competition and geographic competition. Rail customer needs are changing as the transportation market quickly evolves. Railroads are adapting to meet these needs by investing in infrastructure, equipment and technology to provide safe, cost-effective and reliable service.

As the safest and most environmentally friendly way to move freight over land, railroads are the best way to meet the 30% increased freight demand the USDOT predicts to happen by 2040. However, railroads are not guaranteed a slice of the freight transportation pie. Instead, they must earn it by offering the price and service that their customers want while taking on multiple types of fierce competition.

A healthy and competitive freight rail system is critical to our transportation network and our national economy. To be successful in such a competitive marketplace, railroads must have policies that allow them to continually invest back into their network. Unfortunately, proposed regulations like forced switching at the Surface Transportation Board directly threaten rail’s ability to invest.

Serving Many Shippers

Railroads serve shippers from almost every industrial, wholesale, retail and resource-based sector of the economy. For some shippers, transportation costs can determine the transportation mode they select. These dynamics mean railroads must provide reliable and affordable service. The Surface Transportation Board (STB) is the economic regulator of freight railroads.

The STB helps ensure railroads earn adequate revenues and that shippers have access to reasonably priced and efficient rail service. The STB can set maximum reasonable rates or take other actions if a railroad has acted improperly. Most rail customers — including those served by only one railroad — do not need STB regulatory protection because market forces ensure competitive rates and service.

Rail rates have modestly risen in recent years to reflect higher rail input costs and the need for railroads to pay for the record reinvestments in their networks. Yet, there are modest increases compared to many other economic goods and services. While rail rates and input costs have increased in recent years, they have remained down over the last 40 years following regulatory reform.

ASSOCIATION OF AMERICAN RAILROADS

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**Rail Shippers Are Not “Captive”**

Access to only one railroad does not mean there is a lack of transportation options for that shipper. Some shippers mischaracterize themselves as “captive” if they only have access to one railroad. This message is misleading for a couple of reasons. First, most rail customers have always been served by only one railroad, as most shippers cannot economically support two railroads, just like most cities cannot support two MLB teams.

Second, many shippers have other modal options, like trucks or water carriers, to move their products. The reason that most rail traffic is not subject to STB regulation is that there are competitive forces in the marketplace that make regulatory oversight unnecessary. Therefore, a shipper is not “captive” just because two railroads do not come to its front door.

**Rail mergers did not create captive shippers.**

The economic regulator of the industry — the STB — must authorize rail mergers. For over 50 years, if a proposed merger would have reduced rail-to-rail competition, the regulator has either rejected it or imposed mitigating conditions.

In fact, mitigation conditions, like trackage rights, were placed on every major merger since the Staggers Act to ensure shippers that had multiple railroads serving them prior to the merger still had multiple-railroad service following the merger. Most importantly, no merger has allowed a shipper to go from two railroads to one.

In addition, the last major merger was more than 20 years ago. Mergers have done nothing to reduce regulators’ substantial authority to protect shippers against unreasonable railroad pricing or practices, much less create captivity. Instead, mergers created the efficient rail network we have today.

They extended the benefits of single-line service to more shippers, for more commodities, over longer distances while opening new markets for shippers in the process. Railroads passed many of these productivity gains to their customers in the form of lower rates. Today’s Average rail rates are 40% lower than in 1980, meaning the average rail shipper can move much more freight for the same price it paid 40 years ago.

**Rail Investments & Profits**

Rail generates modest profits while making massive investments. There is no evidence railroads are making excessive profits, though — their earnings today are, at best, about average among most industries. Railroads are capital intensive, investing 40 cents out of each revenue dollar into their network. The rail industry’s financial health has improved in recent years. Today, railroads spend approximately six times more than the average manufacturer on capital spending as a percentage of revenue.
Rail volumes, excluding coal, are largely dependent on the state of the economy, especially the parts of the economy related to the consumption and production of goods. As those sectors have grown, so have rail volumes. Rail coal shipments have dropped precipitously in recent years as energy markets have changed.

**Transportation Marketplace Competition**

Rapid technological innovations like autonomous trucks and even hyperloop will only increase the competitive landscape. Here are just a few examples of the many competitive restraints railroads currently face:

- **Rail-to-Rail Competition**: Railroads are private companies that compete against each other for business. Rail customers often have connections to competing railroads, either directly or in conjunction with a short-haul truck movement. Some rail customers can also build (or credibly threaten to build) a new rail line to a competing railroad.

- **Other Modal Competition**: Most rail customers can also ship via trucks, barges and/or pipelines. Trucks are freight rail’s largest competitor. However, trucks use infrastructure (e.g., public highways) subsidized by the federal government, while railroads fully fund their infrastructure. This means the costs trucks offer shippers are artificially deflated. Many experts agree that trucks — not subject to the same type of regulatory scrutiny as railroads — will deploy a combination of autonomous, electric and platooning vehicles soon. These technological advancements could increase delivery times, improve on-time performance and significantly lower trucks’ labor and fuel costs — making trucks even fiercer competition for railroads.

- **Product Competition**: Product competition refers to the widespread ability of a firm to substitute one product for another in its production process. For example, a utility can generate electricity from natural gas (which railroads do not generally carry) instead of coal (which railroads do carry). Similarly, a fertilizer manufacturer may substitute soda ash moved by rail with caustic soda transported by truck. Therefore, product options can also constrain transportation rates.

- **Geographic Competition**: A rail customer can often get the same product from — or ship the same product to — a different geographic area. For example, taconite is a low-grade iron ore that, when combined with clay, creates pellets that can be transported to steel manufacturers and melted into steel. This clay is available from Wyoming mines, served by one railroad, and from Minnesota mines, served by another. Iron ore producers can pit one railroad against the other for clay deliveries. This is another type of real-world competition, called geographic competition, that also constrains rail rates.
• **Shipper Generated Competition**: Shippers can also generate competition between railroads before they build a manufacturing plant. They do this by negotiating favorable contracts when evaluating potential plant locations. Over the long term, shippers can locate or relocate plants on the lines of different railroads. Shippers often make the business decision to locate their facilities at sites with access to only one railroad. This means other factors, aside from having multiple rail service options, can drive the decision to locate a shipper’s facility.

• **Future Competition**: Technological, regulatory or structural changes over time will give shippers leverage over railroads. For example, fracking made natural gas much more abundant and less expensive. In turn, natural gas delivered via pipeline becomes the preferred fuel source for electricity generation, instead of coal delivered by trains. This marketplace disruption constrains the rates railroads can charge for delivering coal to utilities.

Additional technological changes that disrupt the transportation market and increase competition are sure to come in the years ahead, including transformative technologies like the hyperloop. Although we cannot predict the future, we do know that new technologies have the potential to not only disrupt the transportation market but also enhance competition.

**Biden Competition Executive Order**

The Biden administration’s plan to generate sustained and inclusive economic growth is critical to a strong supply chain. Yet, while the administration seeks to improve supply chain efficiency, it simultaneously threatens to impede the freight rail network through new regulations. In early 2021, President Biden introduced a sweeping Executive Order (EO) on Promoting Competition in the American Economy.

A subsection of the order targets rail by seeking to implement “forced switching” regulations, which would significantly burden an industry that keeps goods moving across the country. Forcing railroads to carry traffic for competitors would inject huge inefficiencies into rail transportation and undermine rail investment because if a railroad had to use infrastructure it pays for on behalf of a competitor, its incentive to install the infrastructure in the first place would be sharply reduced. Many of the premises underpinning the EO are mistaken or misleading in the rail context. The Surface Transportation Board (STB) should not turn these false assumptions into misguided regulations.

**Economies of Scale**

Section 1 of the EO asserts, “over the last several decades, as industries have consolidated, competition has weakened in too many markets — with workers, farmers, small businesses, and consumers paying the price.” Therefore, the order is based on the idea that consolidation within an industry can reduce competition and decreases consumer welfare.
Yet, the rail industry’s strength lies in economies of scale: The ability to haul larger loads and longer distances with fewer interruptions than other modes leads to greater efficiencies (e.g., on average, rail is three to four times more fuel-efficient than trucks) and a more productive, cost-effective and reliable industry that’s better able to meet our nation’s transportation needs.

Moreover, as Hoover Institution scholar David Henderson outlined, the EO is a gross oversimplification of competition. “There are only seven major railways in America and, on some routes, only two railways,” says Henderson. “Yet competition is intense. How else can one explain the drop in rail rates paid by shippers?”

This focus on creating more efficient networks that can capitalize on greater economies of scale, improve safety and improve network fluidity (providing better value to customers) is the economic rationale underpinning the changes in the rail industry over the last several decades — not a desire to reduce competition.

In fact, railroads face intense competition from each other, from other transportation modes (especially trucks) and from other competitive forces. The competition between larger, more efficient railroads has led rail rates to decline by 40% (on average) since 1980 as railroads fought for market share and innovated to deliver improved service.

Furthermore, railroads continue to face competition from other modes of freight transportation (such as ubiquitous trucks) across geographic regions and within product segments that the industry hauls. Therefore, the generalizations offered as the main basis of the EO bear little resemblance to the environment fueling growth in the railroad industry over the last several decades.

**Dedicated Workers**

The EO also argues generally: “Consolidation has increased the power of corporate employers, making it harder for workers to bargain for higher wages and better work conditions.” Yet this hardly applies to the railroad industry, where 84% of workers on the large “Class I” railroads are union members and subject to collective bargaining. Likewise, rail worker wages and benefits are significantly higher than the average U.S. employee, totaling $143,000 vs. $93,800, respectively.

What’s more, rail employee wages have grown significantly over the last decade, increasing by nearly 40% between 2009 and 2019, almost double the rate of inflation. Railroads invest significant resources in training their workers to ensure safe and efficient performance on the job. In stark contrast to claims made in the EO, rail continues to build on its foundation of good-paying jobs and invest further in its workforce to meet current supply chain challenges.
Adapting For the Future

Perhaps most misleading in the case of rail, the EO argues that consolidation threatens economic recovery, “endangering our ability to rebuild and emerge from the coronavirus disease 2019 (COVID-19) pandemic with a vibrant, innovative, and growing economy.”

Yet this assertion ignores the railroads’ role as an “essential component of pandemic resilience,” as found by Northwestern University — a role enabled by the flexibility the current regulatory framework allows.

Despite what the July 2021 EO argues and the problematic regulations it encourages at the STB, the rail industry remains competitive, employee-focused and resilient. Forcing railroads to dramatically change their operations in the misguided name of enhancing competition would actually reduce rail competitiveness and hurt the administration’s goals of supply chain resilience and improved environmental outcomes.

A more thoughtful approach to freight rail regulation would build on the current framework’s decades of success and keep American rail vibrant and competitive well into the future.