
THE GEORGE WASHINGTON UNIVERSITY

WASHINGTON, DC

Public Interest Reply Comment¹ on
The Surface Transportation Board's Proposed Rules
Final Offer Rate Review, Docket No. EP 755
Market Dominance Streamlined Approach, Docket No. EP 756

January 10, 2020

Jerry Ellig, Research Professor²

The George Washington University Regulatory Studies Center

The George Washington University Regulatory Studies Center improves regulatory policy through research, education, and outreach. As part of its mission, the Center conducts careful and independent analyses to assess rulemaking proposals from the perspective of the public interest. This reply comment on the Surface Transportation Board's (STB's) proposed rules on Final Offer Rate Review and the Market Dominance Streamlined Approach does not represent the views of any particular affected party or special interest, but is designed to evaluate the effect of the STB's proposals on overall consumer welfare and assist the board in identifying the primary impacts of the proposed rule and feasible alternatives.

Introduction

In two related proceedings, the STB has proposed a streamlined approach to assessing whether a railroad has market dominance³ and a final offer process for small rate disputes.⁴ This reply comment addresses three issues raised by other commenters in these proceedings: (1) Analytical shortcomings postulated by the Association of American Railroads (AAR) in its

¹ This comment reflects the views of the author and does not represent an official position of the GW Regulatory Studies Center or the George Washington University. The Center's policy on research integrity is available at <http://regulatorystudies.columbian.gwu.edu/policy-research-integrity>.

² The author is a research professor at the George Washington University Regulatory Studies Center.

³ Surface Transportation Board, "Market Dominance Streamlined Approach: Notice of Proposed Rulemaking," Docket No. EP 756 (September 11, 2019).

⁴ Surface Transportation Board, "Final Offer Rate Review: Notice of Proposed Rulemaking," Docket Nos. EP 755 and EP 665 (Sub-No. 2) (September 11, 2019).

comments on the final offer rate review proposal,⁵ (2) A proposal by the United States Department of Agriculture (USDA) that the STB use rate benchmarking instead of qualitative assessment to establish a presumption that the railroad is market dominant,⁶ and (3) Proposals by USDA and the American Fuel and Petrochemical Manufacturers that the STB adopt a revenue/variable cost (R/VC) threshold as an indicator of market dominance.⁷

The analytical shortcomings postulated by AAR need not be fatal flaws in the final offer rate review proceeding; the STB can address them by conducting a regulatory impact analysis (RIA) along the lines I suggested in my initial comment.⁸ Substitution of rate benchmarking for qualitative assessment of competitive alternatives would likely create erroneous presumptions of market dominance where railroads are not market dominant, but rate benchmarking could be fruitfully used as a screen to determine whether a rate can be challenged, without creating a legal presumption of market dominance. Because R/VC ratios are based on unreliable Uniform Rail Costing System (URCS) calculations of variable cost, they are not reliable indicators of market power and should not be used to determine market dominance.

Addressing Analytical Shortcomings

The penultimate section of the Association of American Railroads' comment on final offer rate review contends that the proposal "suffers from a host of infirmities." These include (1) the absence of an assessment of how the proposal would affect railroad revenue adequacy, (2) the absence of a benefit-cost analysis, (3) the absence of a statement indicating whether the rule is required by law or whether existing rules have created the problem the rule seeks to address, and (4) the absence of an analysis that would allow OIRA to determine whether the rule is "major" under the Congressional Review Act.⁹

⁵ "Comments of the Association of American Railroads," Final Offer Rate Review: Notice of Proposed Rulemaking, Docket No. EP 755 (November 12, 2019) at 24-26.

⁶ "Comments of the U.S. Department of Agriculture," Final Offer Rate Review: Notice of Proposed Rulemaking, Docket No. EP 755 (November 12, 2019) at 10-11.

⁷ "Comments of the U.S. Department of Agriculture" at 11, and "Comments of American Fuel and Petrochemical Manufacturers," Market Dominance Streamlined Approach: Notice of Proposed Rulemaking, Docket No. EP 756 (November 12, 2019) at 5.

⁸ Jerry Ellig, "Public Interest Comment on the Surface Transportation Board's Proposed Rules: Market Dominance Streamlined Approach, Docket No. EP-756, Final Offer Rate Review Docket Nos. EP 755 and EP 665 (Sub-No. 2), and Solicitation of Information: Association of American Railroads – Petition for Rulemaking, Docket No. EP 752," November 6, 2019, <https://regulatorystudies.columbian.gwu.edu/stbs-market-dominance-and-final-offer-rate-review>.

⁹ "Comments of the Association of American Railroads" at 24-26.

The STB could adequately address these concerns by conducting a regulatory impact analysis as outlined in my initial comment.¹⁰ An RIA would address the effects of the proposal on railroad revenue adequacy by estimating its effect on railroad revenues¹¹ and assessing whether that revenue effect would impair railroad investment.¹² An RIA would include a benefit-cost analysis. An RIA would contain an analysis of the underlying problem, which would include an assessment of whether existing rules have created or exacerbated the problem and a clarification of whether the rule is required by law. Finally, an RIA that provides even rough estimates of the likely transfers, benefits, and costs would provide the information OIRA needs to determine whether the regulation is major.

Replacing Qualitative Factors with Rate Benchmarking

Factors 2-6 in the STB's list of factors to establish a prima facie case for market dominance are qualitative factors that assess whether the shipper has access to actual or potential rail, truck, or barge competition. The former members of the Transportation Research Board's Committee for a Study of Freight Rail Transportation and Regulation (TRB Study Committee) suggested that the STB should employ competitive rate benchmarking as an additional factor to make a prima facie case that a railroad is market dominant.¹³ The USDA, in contrast, proposes that the STB could replace factors 2-6 with competitive rate benchmarking.

Under the USDA's proposal, the STB would use rail rates and characteristics of shipments in markets deemed competitive to construct an econometric model of rate determination. A shipper that believes it may have a valid rate complaint could use that model to predict the rate it would pay for that shipment in a competitive market. If the disputed rate exceeds the competitive rate by an amount greater than a threshold selected by the STB, the railroad would be presumed to be market dominant.¹⁴ USDA appears to assume that, in the context of the Streamlined Market

¹⁰ Ellig, "Public Interest Comment on the Surface Transportation Board's Proposed Rules."

¹¹ For example, in an exhibit sponsored by the American Chemistry Council, Kevin W. Caves demonstrates how to calculate the amount of railroad revenue at stake using the benchmark model he developed. See "Verified Statement of Dr. Kevin W. Caves," Final Offer Rate Review: Notice of Proposed Rulemaking, Docket EP-755, November 12, 2019, at Table 5.

¹² A recent study finds that railroad investment is positively related both to revenue and returns. See George S. Ford, "Infrastructure Investment in the Railroad Industry: An Econometric Analysis," Phoenix Center Perspectives (December 9, 2019), <https://phoenix-center.org/perspectives/Perspective19-07Final.pdf>.

¹³ Kenneth D. Boyer, Jerry Ellig, José A. Gómez-Ibáñez, Anne V. Goodchild, Richard L. Schmalensee, Wesley L. Wilson, and Frank A. Wolak, "Public Interest Comment on the Surface Transportation Board's Notices of Proposed Rulemaking: Docket No. EP 755, Final Offer Rate Review, and Docket No. EP 756, Market Dominance Streamlined Approach," October 17, 2019. These individuals' comments are based on the report they produced for the Transportation Research Board, MODERNIZING FREIGHT RAIL REGULATION, Transportation Research Board Special Report No. 318 (2015), <https://www.nap.edu/download/21759> [Hereinafter referred to as "MODERNIZING FREIGHT RAIL REGULATION."]

¹⁴ "Comments of the U.S. Department of Agriculture" at 10-11.

Dominance proposal, the defendant could present evidence to refute this presumption: “Even if a shipper meets the screening criteria, the railroad still can rebut before a Board determination is made and before a rate reasonableness test even begins.”¹⁵ Nevertheless, a railroad would be presumed to be market dominant if the rate exceeds the STB-determined benchmarking threshold and the statutory revenue/variable cost ratio of 180 percent.

This approach would likely create a presumption of market dominance in many cases where the shipper actually has one or more competitive options. The reason is that all econometric models have prediction errors. Unusually high rates identified by a benchmarking model could be caused by market dominance, or they could be caused by other factors not included in the benchmarking model. Qualitative factors 2-6 in the STB’s proposal would help prevent the STB from presuming a railroad is market dominant when an unusually high rate is caused by something other than market dominance. Retaining those factors would make market dominance determinations that include rate benchmarking more accurate.

The USDA proposal might appear to make the combination of Streamlined Market Dominance and Final Offer Rate Review similar to the procedure the members of the TRB Study Committee proposed in their original 2015 report.¹⁶ That report proposed to use an econometric rate benchmarking model to identify rates that seem unusually high for further scrutiny. Such scrutiny, to be conducted by an arbitrator, would include an assessment of market dominance with strict time limits but no restrictions on the types of evidence about market dominance that could be considered.

There is a key difference between the USDA proposal and the TRB Study Committee’s 2015 proposal. The USDA proposal would use benchmarking to create a presumption that a railroad is market dominant. The TRB committee’s proposal would use benchmarking to identify rates that should be subject to more extensive scrutiny, but it did not propose to create a legal presumption that a rate above the STB-selected threshold indicates market dominance.

If the STB wants to use rate benchmarking as an initial, numerical screen to determine whether a rate case can proceed, it can do so without creating a presumption that rates above the benchmark threshold indicate market dominance. First, the challenged rate would be compared to the competitive benchmark rate, and the rate case could only proceed if the challenged rate exceeded the competitive rate by a percentage established by the STB. Second, for rates that exceed the STB-established threshold, the STB would undertake either a streamlined or regular market dominance inquiry. Third, if the railroad is found to be market dominant, the STB would select either the railroad’s or the shipper’s final offer.

¹⁵ Id. at 8.

¹⁶ MODERNIZING FREIGHT RAIL REGULATION at 206-07.

Higher R/VC Ratio to Establish Market Dominance

A railroad cannot be found market dominant if the rate for the shipment is at or below 180 percent of variable cost,¹⁷ but an R/VC ratio exceeding 180 percent creates no presumption of market dominance.¹⁸ Two commenters proposed that the STB adopt a higher R/VC ratio that would establish market dominance. The USDA proposes that an R/VC ratio exceeding 200 percent should create a presumption of market dominance.¹⁹ The American Fuel and Petrochemical Manufacturers propose “that STB adopt regulations stipulating that when a R/VC ratio of greater than 280% is demonstrated, market dominance is declared automatically without consideration of any other factors.”²⁰

The STB should reject any proposals that would make its decisions more dependent on variable cost calculations based on the Uniform Rail Costing System (URCS). URCS-derived R/VC calculations are simply not reliable guides to identifying railroad market power.²¹ Therefore, it would be arbitrary to expand the use of R/VC ratios to infer market dominance.²²

Conclusion

Based on the foregoing, I offer the following recommendations:

- (1) The STB can address the “host of infirmities” alleged by AAR by conducting a regulatory impact analysis.
- (2) Rate benchmarking should not be a substitute for the proposed qualitative factors 2-6 to establish a prima facie presumption of market dominance. Rate benchmarking should either be employed as an additional factor to consider, or it should be used as a screen to identify which rate complaints can proceed to a market dominance determination.
- (3) R/VC ratios should not be used to establish a presumption of market dominance, because they are based on inherently arbitrary URCS calculations of variable costs.

¹⁷ 49 U.S.C. § 10707(d)(1)(A).

¹⁸ 49 U.S.C. § 10707(d)(2)(A).

¹⁹ “Comments of the U.S. Department of Agriculture” at 11.

²⁰ “Comments of American Fuel and Petrochemical Manufacturers” at 5.

²¹ MODERNIZING FREIGHT RAIL REGULATION at 107-22; Wesley W. Wilson and Frank A. Wolak, “Freight Rail Costing and Regulation: The Uniform Rail Costing System,” 49 *Review of Industrial Organization* 229 (2016).

²² In defense of its proposal, USDA notes, “Notwithstanding the statutory requirement and academic literature surrounding the flaws of the URCS, USDA agrees it is relatively straightforward to calculate variable cost using the Board’s URCS Phase III.” “Comments of the U.S. Department of Agriculture” at 11. While the calculations may be straightforward, they will often be misleading. Thus, this argument is equivalent to arguing that a driver should look for lost car keys under a street light instead of where he dropped them because the light is brighter there.