Committee on Transportation and Infrastructure
U.S. House of Representatives
Washington, DC 20515

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May 8, 2015

SUMMARY OF SUBJECT MATTER

TO: Members, Subcommittee on Railroads, Pipelines, and Hazardous Materials
FROM: Staff, Subcommittee on Railroads, Pipelines, and Hazardous Materials
RE: Subcommittee Hearing on "The 35th Anniversary of the Staggers Rail Act: Railroad Deregulation Past, Present, and Future"

PURPOSE

The Subcommittee on Railroads, Pipelines, and Hazardous Materials will meet on Wednesday, May 13, 2015 at 10:00 a.m. in 2167 Rayburn House Office Building to receive testimony on the 35th anniversary of the *Staggers Rail Act of 1980* (Pub. L. No. 96-448) from representatives of the Surface Transportation Board, the American Chemistry Council, the Association of American Railroads, and the American Short Line and Regional Railroad Association, as well as a Professor of Economics at Georgetown University.

BACKGROUND

Named after former House Interstate and Foreign Commerce Committee Chairman Rep. Harley Staggers (D-WV), the *Staggers Rail Act* was signed into law by President Jimmy Carter on October 14, 1980. The *Act* replaced an outdated regulatory structure that had existed since the *Interstate Commerce Act of 1887*, and is widely credited with saving the freight rail industry in the face of bankruptcy.

The Railroad Industry Pre-*Staggers*

The railroad industry was the first industry in the United States to be regulated by the federal government; it began with passage of the *Interstate Commerce Act of 1887* (ICA), which created the Interstate Commerce Commission (ICC). Over the next century, the ICC's regulatory authority became engrained in nearly all aspects of railroad operations, including rate setting and mandated service structure and practices.

Specifically, railroads were not able to price services based on market conditions, as any proposed change in price required ICC approval. Even as costs and inflation rose, the ICC was reluctant to allow rates to be raised on shippers.

Furthermore, ICC rate regulation established rate floors that kept railroads from undercutting other less efficient modes of transportation. In other words, even in those instances where railroads could compete with other modes, regulations kept them from doing so. Intra-modal competition was also nonexistent as railroads were kept from competing with one another because rate bureaus and rate equalization rules required each railroad to charge the same price for the movement of a particular commodity.

Long-term contracts between railroads and shippers were also barred by the ICC. Railroads could not offer shippers lower rates for guaranteed traffic or privately negotiate specific service levels or specialized service for a premium. Similarly, if two railroads wanted to engage in cooperative service and divide a movement amongst themselves, the ICC rules set the division of the rates and established the terms, with little or no flexibility for the rail carriers.

This involvement in the provision of service meant the railroads could not recover the high costs associated with operating the railroad and investing in infrastructure improvements, equipment, or any additional costs to develop technological advances for the industry. The regulatory environment, therefore, was such that it did not incentivize investment, nor did it allow railroads to attract capital, leading in turn to a loss of market share to other more efficient modes.

On top of the rate-related regulation, the ICC made entry and exit to the industry extremely difficult, essentially precluding consolidation and overextending the network. Railroads could not abandon unprofitable lines, meaning each had to bear the costs of inefficient, low-density lines and continue to provide common carrier service, even though the costs were high and the rates were artificially low. The railroads also faced increased competition from the federally-assisted development of the Interstate Highway System and navigable waterways.

The impacts of over-burdensome regulation were drastic. In the 30 years pre-*Staggers*, railroads' market share measured by revenue ton-miles dropped 33 percent.[1] So, while the intercity tonnage of freight from 1947 – 1977 almost doubled, the railroads carried 91 percent fewer tons than it had 30 years earlier.[2] Further, the total revenue of railroads over that time period dropped from 70 percent to 30 percent. The rate of return on investment averaged between two and three percent, down from more than double that in the 1940s.[3] This led to a number of Northeastern and Midwestern railroads filing for bankruptcy. By the end of the 1970s nearly 22 percent of all rail miles were under bankruptcy protection.[4] In 1978, the Department of Transportation transmitted a report to Congress entitled "A Prospectus for Change in the

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[1] Federal Railroad Administration, U.S. Department of Transportation, *Impact of the Staggers Rail Act of 1980*, March 2011.
[2] Richard Dash, *The Staggers Rail Act of 1980: Authority to Compete with Ability to Compete*, 12 Transp. L. J. 301, 302-03 (1982).
[3] H. Report. No. 96-1430 (1980).
[4] Association of American Railroads, *The Impact of the Staggers Rail Act of 1980,* May 2014.

Railroad Industry," which concluded that the industry would have a capital shortfall of between $16 billion and $20 billion by 1985, leading to significant concerns about deteriorating track conditions, poor service, and safety. In fact, according to the industry, by 1976, more than 47,000 miles of track had to be operated at reduced speeds because of unsafe conditions.

The *Staggers Rail Act's* Deregulatory Features

The *Staggers Rail Act's* overarching goal was the revitalization of the railroad industry, by allowing more competition and removing regulatory burdens. The *Staggers Act* was based on the premise that the competitive market should serve as the model for regulation, and regulatory action should be taken only when market forces are insufficient to deter an abuse of market power. The *Staggers Act* removed regulatory impediments to the railroads' ability to earn adequate revenues.

Entry and Exit Licensing

Prior to *Staggers*, barriers to entry, and more importantly, exit were difficult. The ICC would not freely allow railroads to enter the market to provide service, nor could a railroad easily abandon or discontinue service when the economic forces did not justify the continued service. *Staggers* lessened the requirements for the authorization of new construction of lines, while prohibiting one carrier from blocking another carrier from constructing across its line. These changes would allow railroads to build out and serve new markets. More significantly, the *Staggers Act* reduced the regulatory burdens of exiting from the market by streamlining the process for abandonment of rail lines and discontinuance of rail service. To avoid a discontinuance or abandonment, the *Staggers Act* also provided procedures to allow interested parties to make offers of financial assistance to continue service or purchase the line that was the subject of the abandonment.

The new procedures for exit licensing had several important effects on the industry. First, it allowed railroads to respond to market forces by shedding lines or discontinuing service where demand did not justify the continued costs to maintain the line. In turn, this allowed railroads to increase investment in the plant where demand justified the service and reduce investment where demand did not require the capital expenditures. This change in regulatory structure helped to efficiently size the railroad network based on market forces rather than regulatory requirements.

Second, by including provisions to allow offers of financial assistance and ease the sale of line subject to abandonments, the *Staggers Act* preserved rail service that may otherwise have been lost. In so doing, it spurned the development of the short line and regional railroad industry. Where larger railroads did not see the benefit of operating lower density lines, the short line and regional railroad carriers would purchase those lines and provide more targeted service at lower costs, thus preserving service while developing an industry unto itself.

Competition and Ratemaking Freedom

The primary change to railroad regulation was that the *Staggers Act* introduced competition to the rail industry by allowing market conditions to govern rates. Instead of rigid rate-setting by regulation, railroads themselves could base their particular rate on the demand for service and competitive market forces. It was the first time Congress recognized that different products and different services justified different pricing arrangements (hence the term, differential pricing). Federal regulators were only to step in where either inter- or intra-modal competition was absent and a railroad's market dominance was evident based on the ratio of 180 percent of revenue to variable cost (R/VC) of the railroad.[5]

This new rate regulatory structure left regulatory intervention to situations only where the absence of competition led to an abuse of market power or unreasonably high prices. Thus, it created the leeway to ensure railroads could differentially price their services based on the demand, allowing railroads to recover their high fixed costs.

Staggers also gave railroads the freedom to enter into long-term contracts for service. Not only could the market dictate the rates in the contract, but also the level, quality, quantity, and type of services to be provided. Under the *Staggers Act* contracts were subject to approval by the ICC, and if not approved within the allotted time, the contract went into effect. Once in effect, the movement of traffic under that contract would not be subject to regulation. However, if the contract interfered with the carrier's ability to fulfill its common carrier obligation, the ICC could intercede.

Similarly, the *Staggers Act* allowed the ICC to exempt from regulation types of traffic or particular practices for which there was effective competition. If a traffic type or practice entailed no threat of an abuse of market power, the ICC's authority to exempt that traffic practice from regulation was enhanced.

ICC Termination Act of 1995

In 1995, Congress passed the *ICC Termination Act of 1995* (*ICCTA*), (Pub. L. No. 104-88), which was the last legislative action related to railroad deregulation. *ICCTA* eliminated the expansive ICC and transferred some of its functions, predominantly those related to the regulation of railroads, to the Surface Transportation Board (STB or Board). ICC functions that were not transferred to the STB were either eliminated by *ICCTA* or transferred to the Secretary of Transportation, including functions involving motor carriers and freight intermediaries that were not expressly assigned to the STB.

The three-member, bipartisan Board now has regulatory jurisdiction over railroad rate reasonableness, mergers, line acquisitions, new rail line construction, abandonments of existing rail lines, and the conversion of rail rights-of-way to hiking and biking trains.

[5] Variable costs are expenses that can be attributed to a particular service and that change in direct relation to the provision of that service, e.g., fuel.

The Board is decisionally independent, although it is administratively housed within the U.S. Department of Transportation. The STB's authorization expired in 1998, and the agency has remained unauthorized since that time, each year submitting a budget request directly to Congress for necessary appropriations. The Board has approximately 150 employees and receives a modest annual appropriation of about $32 million that is offset with collections from railroad-shipper filing fees (capped under the appropriations bills at $150,000).

The STB's major responsibilities related to railroads include: overseeing and monitoring railroad commercial practices nationally; enforcing the railroads' common carrier obligations; evaluating challenges to the reasonableness of rail rates; monitoring rail carriers to ensure they are able to earn adequate returns necessary for the continued health of the rail system, which includes calculating the rail carriers' cost of capital; and authorizing construction, operation, discontinuance, and abandonment of rail lines and service.

In addition, the STB has several informal programs to help resolve railroad-shipper disputes, questions on rates and other charges, railroad-car supply and service issues, claims for damage, interchange issues, employee complaints, and community concerns. Finally, the STB has established a Railroad-Shipper Transportation Advisory Council, the Grain Car Council, and the Rail Energy Transportation Advisory Committee to receive input from the railroads and industry on various issues before the Board.

After *Staggers* and Looking Ahead

The post-*Staggers* rail industry has seen marked improvement in rates, revenues, productivity, safety, and volume growth, all largely due to the freedom of the industry to recover its costs and strive toward earning adequate revenues. Freedom to set rates means that technological and productivity enhancements can be pursued since costs can be recovered. Indeed, enhancements in productivity, over 130 percent since passage of the *Staggers Act*, has led to more efficient service and lowered costs.[6] And where cost savings were found, shippers have shared in that reduction. According to the Federal Railroad Administration, shippers have seen a significant decline in rates. Freight rates adjusted for inflation have declined 0.5 percent a year since passage of the *Staggers Act*, compared to an increase of nearly three percent per year in the five years prior to 1980.[7] Although rail rates have seen some increases in the past few years, the industry maintains they are still well below pre-1980 levels.

The railroads' financial health has also improved with the return on investment of the railroads increasing from an average of two to three percent in the 1970s to a projected 12.9 percent in 2014.[8] Similarly, market share has increased to 40 percent.[9] These financial improvements have allowed the railroads to reinvest in the network $575 billion since *Staggers* was passed.[10] Furthermore, the network has been right-sized through the elimination of

[6] Association of American Railroads, *The Impact of the Staggers Rail Act of 1980*, May 2014.
[7] Federal Railroad Administration, U.S. Department of Transportation, *Impact of the Staggers Rail Act of 1980*, March 2011.
[8] Id.; Association of American Railroads (2015).
[9] Association of American Railroads, *The Impact of the Staggers Rail Act of 1980*, May 2014.
[10] Association of American Railroads, *Freight Railroad Capacity and Investment*, Jan. 2015.

inefficient lines or service, many of which are now operated by lower-cost short line railroads, which has also been made possible via decreased regulatory barriers.

While pricing has been a function of market rates, the regulatory policy established by *Staggers* has been designed to protect the public interest by preserving competition and intervening when markets forces fail. Where regulation established many hurdles on the front end to railroads' pricing, now the regulatory structure provides protections on the back end for those instances where market dominance leads to an abuse of market power.

Shippers, however, maintain that while the *Staggers Act* has been successful in many ways, the freight rail service landscape has changed dramatically, leading to disputes between rail carriers and rail shippers over rail rates, access, and service. According to the shippers, "Many shippers – generally those in the chemical, coal, and agricultural sectors with access to only one carrier – believe that the dramatic consolidation of the nation's freight rail network, from 26 Class I railroads in 1980 to four corporations that control more than 90 percent of the market, has led to unreasonable rate increases, service breakdowns, and diminishing competition."[11] These shippers contend that the STB has not taken enough action to protect shippers from rail carriers and that current law has made it difficult for them to obtain rate and service relief.

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[11] Hearing on "Freight Rail Service: Improving the Performance of America's Rail System" Before the Senate Committee on Commerce, Science, and Transportation, 113th Cong. (2014) (statement of Cal Dooley, President and CEO, American Chemistry Council).

WITNESS LIST

The Honorable Debra Miller
Acting Chairman
Surface Transportation Board

The Honorable Calvin Dooley
President and Chief Executive Officer
American Chemistry Council

The Honorable Edward R. Hamberger
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