The Merger Movement and the Functional Change of the U.S. Railroad Industry

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The Voyager: The TRANSLOG International News-Journal for the 21st Century
October-December 2004
Volume VI, Number III

In this article we will examine the balance between private and public interests prior to the Staggers Rail Act, (which partially deregulated the U.S. rail system in 1980) during the implementation of the Act, and now, in light of the great consolidation of the rail industry brought about by the mergers of the 1980s and 1990s.

The Pre-Staggers "Balance"
To get a feel for the operational impact of the railroad merger movement on today's rail industry it is useful to remember the strategic balance between the carriers and shippers that existed prior to the Staggers Act. It is equally important to remember that the environment engulfing that relationship was one of an increasing perception of institutional failure, both governmental and industry. After the collapse of the PennCentral and its various connecting Northeastern railroads, and the growing threat of further Midwestern railroad failures (the Rock Island and Milwaukee Road) Congress could no longer ignore this vital industry or leave its problems to the Interstate Commerce Commission (ICC) to be sorted out under unchanged regulatory statutes. We will discuss this more fully below but it is a necessary backdrop for a consideration of the carriers' and shippers opposing comparative advantages at the advent of the Staggers Act.

At that time the shipping community enjoyed well established tactical advantages such as:

Railroad Connectivity: It has long been established that U.S. railroads must interchange traffic without discrimination throughout their extensive system. Mandatory interchange, along with growing inter-carrier trackage rights (either imposed as merger conditions or voluntarily assumed) made the multi-carrier U.S. railroad system operate as a true network. Given the vast number of actual and potential interchanges in the 170,000+ mile system, along with the requirement for rate tariff transparency in their negotiations with alternative carriers and carrier combinations, shippers had access to myriad route combinations for their traffic, and also could rely on the ICC to enforce service obligations by potential carriers.

Non-Discrimination: Bolstering the shippers' routing obligations was the assurance that they had remedies available at the agency if there was any perceived discriminatory treatment. The ICC spent an inordinate amount of enforcement effort tracking down and disciplining carriers appearing to give preferred shippers special "unwarranted" treatment. Contact-like preferences were illegal *per se*. This had a profound impact on railroad management, effectively emasculating any real "marketing" initiatives prior to Staggers.

Confidence in Rate Adjudication: Regardless of one's philosophical view of the underlying policy, the ICC had acknowledged expertise concerning the tariff-based railroad ate structure. Shippers had no hesitancy turning to the agency to invoke its adjudicatory processes in this area.

The carriers, on the other hand, did not have comparable comparative advantage prior to Staggers. Because of the Elkins Act (which prohibited unequal treatment of rail shippers) they could not effectively offer their services under the full range of marketing techniques. Nor could they promote special shippers relationships without risking undue attention by the Commission's Bureau of Enforcement. The carriers could, however, invoke the Commission's process to adjust their overall rate by means of:

General Revenue Proceedings: In these *ex parte* proceedings the rail industry periodically presented voluminous data supporting requests for across-the-board revenue enhancements. These proceedings, however, always begot extensive litigation both before the agency and in court with the resulting delay

often eating the very relief sought. The fact that the industry, as a whole, could not earn its cost of capital graphically underscores the weakness of this procedural "advantage."

Attempting to balance the conflicting positions of the carriers and shippers at the threshold of Staggers was a very powerful ICC. It enjoyed comprehensive powers over the industry. These ranged from rate and practice oversight to merger jurisdiction, and also included extensive jurisdiction over passenger train service (prior to the creation of Amtrak), securities jurisdiction (later ceded to the SEC in the wake of the PennCentral "holding company" debacle), abandonments, and bankruptcy reorganizations (greatly reduced by the Bankruptcy Reform Act of 1976). The agency was well staffed to meet its extensive responsibilities with more than 70 Administrative Law Judges in place to hear its burgeoning administrative case load. When judicial review of the ICC's decision passed from the special Three-Judge District Courts to the U.S. Court of Appeals under the Hobbs Act in 1977, the case load for the District Circuit more than doubled.

In short, the agency which "balanced" the interest of carriers and shippers pursuant to statutory Congressional policy prior to the Staggers Act was a powerful one. But it became increasingly clear that exercises of its power without a change in the underlying policy could not save the industry from collapse. A policy change, the Staggers Act, had to do that.

Functional Change: Implementation of the Staggers Act

In real sense today's railroad practices and structure have their origins in the creeping bankruptcies of the 1970s. In 1970 the rail industry was in distress. Over 25% of the nation's rail plant were under the control of bankruptcy trustees. Rail dependent heavy industry was threatened with failing but necessary rail service.

In these circumstances Congress faced difficult choices. Was nationalization of this basic industry the answer? Given the parlous state of the industry, would deregulation even work? And what to do about rail passenger service? Isn't rail access a basic "right" expected in an industry and mobile society?

To appreciate the complexity of the issue facing Congress with the incipient collapse of the private sector rail industry we should examine the structure of the industry as it existed in the 1970s prelude to the Staggers Act. Similarly, to appreciate the profound operational changes wrought by the merger movement unleashed by the Staggers Act we should keep in mind the shippers pre-Staggers comparative advantages outline above.

In 1970 there were more than 40 Class I railroads making up the patch work quilt of the U.S. rail system. This multiplicity of carriers, however, was forced to operate as a network by laws compelling mandatory interchange and a uniform rate structure embodied in public tariffs and enforcement by a powerful agency. Carriers routinely provided join line service and multi-line movement of their cars, along with an effective interline settlement mechanism, effectively creating a shared national car fleet. The railroads recognized, and the Commission enforced, common carrier obligations. Preferential treatment of any shipper, no matter how important, invited scrutiny from the ICCs Bureau of Enforcement. Transportation contracts between carriers and shippers were strictly forbidden.

It is no surprise that railroad marketing initiatives was frustrated under this regime. Railroad marketers developed more of a "public utility" mentality than an entrepreneurial spirit under the Commission's execution of its perception of Congressional policy. Congress thus faced a demoralized but economically necessary private sector industry when it considered what to do with the emergent railroad crisis. Congress took a number of steps to avoid nationalizing a rail freight industry that could not earn its costs of capital and was shrinking its plant as fast as it could to contain cost. First it relieved the railroads of their obligation to provide chronic red ink rail passenger service by creating Amtrak. Nest it passed the Staggers Act that effectively deregulated the bulk of the railroad's rate structure. While it kept in place the mandatory interchange practices that forged a system out of interconnected carriers, it also allowed individual contract ratemaking. This is the key to the industry's revitalization. It is also the spark that ignited the merger movement.

The industry seized the opportunity to assure market share through merger. Over the last 20 years the 40+I class merged themselves into a now-stable industry structure of 4 mega-system and a relatively small collection of regional railroads. In the merger process the large trunk line carriers often spun off duplicative rail plant to new short-line carriers. There are now upward of 600 shortline carriers with varying degrees of participation in the national rail system.

The merger movement not only produced corporate concentration, it significantly changed the physical flow over the total rail network. The merger carriers emphasized high-density lines by channeling freight onto their most efficient corridors at the coat of other previously competitive lines. These carriers have "succeeded" in building density over preferred lines to such a degree that they have already experienced "capacity constraint" problems well in advance of the predicted onslaught of new international/intermodal traffic flow. The scope of the oncoming capacity problem was only hinted at by Norfolk Southern (NS) and CSX's problems digesting new traffic flows arising out of the Conrail split. Equally, or perhaps more important. the Staggers inspired merger movement has turned the previously discussed comparative advantages of shipper and carrier on their heads. This may have grave consequences if the rail industry finally turns to the federal government as a partner in infrastructure maintenance and development.

New Post-Merger Relationships

We can now assess the Staggers inspired mergers' collective impact on shipper-carrier relationships using the comparative advantage measures outlined above. It is an understatement to say they have been radically changed. All of the previously shipper advantages have been either diminished or nullified.

Railroad Connectivity: Mandatory interchange is still in effect and has been an enormous elimination of meaningful alternative routing possibilities in the postmerger railroad map. As the mega-systems have channeled traffic onto their favored higher density lines, the less favored, formerly competitive lines have either been sloughed off or have suffered comparative neglect as the carriers marshal their limited infrastructure resources to their favored lines. On a simpler basis, the reduction of 40+Class I to a 4 mega system has eliminated all constituent pre-merger routing alternatives. This is no longer a shipper comparative advantage.

This is an area of concern on another dimension. There is growing concern that the Class I density packing techniques are slowly disconnecting the short lines from full participation in the network. Heavier cars and volume demand ratemaking are making it increasingly difficult for many short lines and their constituent shippers to be a meaningful member in the system. This has long range policy implications, which are not necessarily advantageous to the economy.

Common Carrier Obligations: While there may still be vestiges of the common carrier obligation in the rail industry, under the current Class I traffic mix it is approaching practical meaninglessness. Given the extent of explicitly deregulated traffic (boxcars, etc.) and the vast preponderance of other traffic moving under transportation contracts, the principal carriers have relatively little resources available for common carrier obligation, in practical terms the Class I railroad industry is becoming a "contact carriage" industry.

Non-Discrimination: This has been totally revoked by the Staggers Act. The former ICC's whole mechanism for individual shipper protection no longer exists under the contract carriage regime.

Confidence in Rate Adjudication: A look at the Surface Transportation Board's active docket quickly shows that the shippers are not turning to that forum for rate relief. This may be partially explained by the complexity and expense of bringing an action under the "stand alone" costing procedures. The expense of the remedy has not been shown to warrant the potential rewards. The absence of small shipper recourse to the Board is particularly telling. Whatever the reason shippers are simply not using the Board's procedures. Non-use is tantamount to a vote of non-confidence.

The carriers, on the other hand, have completely reversed their position under Staggers. Instead of a general revenue proceedings, the carriers' use of contract ratemaking (based on the market power of the surviving merged carriers) has saved the industry from nationalization. But this has come at the coat of changing the former interconnected common carrier into a contract carrier oligopoly.

Finally a brief comparison of the postmergers Surface Transportation Board with the pre-Staggers ICC is in order. Congress has greatly reduced the Board's power *vis-a-vis* the ICC's. The Board cannot be faulted for that. Further, the rate expertise that was built over the years at the ICC cannot be expected to be duplicated by the smaller Surface Transportation Board (STB) staff. Yet the continuing complaint is made that the STB has not provided an adequate forum and procedures for shippers large or small. The relative paucity of rate cases at the Board speaks volumes.