

On this monopoly board, railroads are winning

By Edward Lotterman
January 9, 2008

Dow Chemical, Xcel Energy and Idaho barley farmers might not seem to have much in common, but all are "captive shippers." All depend on rail transport for shipping key raw materials or products yet can get service from only one railroad. For them, monopoly power in a deregulated industry is a major headache.

Economic policies often follow pendulum swings. Societies perceive a problem and get government to take some action. But over time, the perceived solution does not work as well as anticipated. Or it introduces other harmful but unanticipated side effects. A political reaction sets in, the now-troublesome policy is reversed and the pendulum begins to swing the other way. Eventually the original problem that touched off the cycle rears its ugly head again.

This is certainly true in the railroad industry. As railroading mushroomed after the Civil War, railroad companies had great monopoly power, and they abused it. Before trucks and modern highways, most shippers had no alternative to trains. Generally, only large communities or large factories were served by more than one railroad.

Economic theory demonstrates that a monopoly will not only charge higher prices than would prevail under competition, but also will provide less of its good or service than is optimal for society. Moreover, monopoly power causes resources to be used inefficiently.

Railroads abused the public. In response to outrage, the federal government established the Interstate Commerce

Commission in 1887 to regulate railroad rates and service.

Over time, regulation grew more and more complex. By the 1930s, a railroad had to file a special rate application to the ICC just to offer a one-time special train for Notre Dame students to attend an away football game. The industry became sluggish. Innovation vanished. Returns on investment were low. Service often was poor.

The Carter administration, advised by Cornell economist Alfred Kahn, introduced deregulation of transportation rates and routes. In 1980, the Staggers Act, named for Rep. Harley Staggers of West Virginia, abolished most federal economic regulation of railroads. Although the ICC survived, it eventually was transformed into a Surface Transportation Board with limited powers.

Overall, the Staggers Act seems a success. Railroad service improved for many. Railroads invested in new locomotives and infrastructure. Management improved, as did returns on equity. Innovation returned to a once-moribund industry.

But for many shippers, railroads retained great monopoly power. That power grew as the industry consolidated into a handful of large railroads. Deregulation benefited customers with access to two railroads, but those captive to only one line for shipping low-value commodities like grain, fertilizer, industrial chemicals or coal often are worse off.

The Staggers Act recognized this danger. The Surface Transportation Board has statutory authority to act when a shipper feels it suffers abusive freight rates, but some now wonder whether the board is using that authority properly. Many shippers feel the board is tilted far too heavily in favor of the railroads.

Convincing the board a freight rate is unreasonable is no easy task and can take years. Shippers must prepare economic studies at great expense. Moreover, the threat of eventual retaliation by railroads in the form of bad service deters some shippers from pursuing redress from monopolistic rates.

Railroad advocates retort that their industry also faces financial pressures. For years their cost of capital exceeded any real return they might get from new locomotives, switching yards or tracks. Only in recent years has profitability increased enough for them to make major investments.

Moreover, Wall Street never seems satisfied with railroad profits. TCI, a large hedge fund with a stake in CSX, the nation's sixth-largest railroad, recently demanded that its board gut the company's long-term investments to pump up short-term profits.

If the STB becomes more responsive to shipper complaints, railroaders warn, the advances the industry made over the past quarter-century will evaporate.

To economists, it seems obvious that monopoly power is causing damage. They don't agree, however, on how to solve it.

Minnesota Democrats Rep. Jim Oberstar and Sen. Amy Klobuchar, among others, have supported thoughtful compromise measures in a 2007 rail competition bill. It is opposed by the Bush administration, in which railroad advocates have a major voice (Vice President Dick Cheney was a director of Union Pacific, and former Treasury Secretary John Snow headed CSX).

The public ultimately bears the cost of monopoly power, but because it is hidden in their electric or feed bills, they don't perceive it as a problem. This is an issue that is not going to go away, but there is no clear solution on the horizon.