The Ties that Bind: Railroads, Coal, Utilities, the ICC, and the Public Interest

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I. INTRODUCTION

During the past century, a symbiotic relationship has developed be-

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tween coal producers, railroads, and major consumers of coal, principally the steel and electric utility industries. Coal has provided many railroads with a fairly stable base load of traffic which could absorb much railroad overhead. Even if these bulk shipments were not always as profitable to the railroads as some other, more valuable shipments on an individual basis, coal did provide a steady, dependable flow of high volume, easy to handle, fairly remunerative traffic.[1] Traditionally, when coal faced severe competition from other energy sources, the railroads would forego rate increases on coal, minimize increases, or even lower rates in an effort to keep the mines operating (and, of course, minimize erosion of their base load traffic).[2] Naturally, carriers and producers did not always agree on transportation rates and there have been many complaints over the years from coal producers and others that railroads were charging excessively high rates and thus were stifling attempts by coal companies to expand their production. Concerns about service quality also have been voiced. For the most part, however, the system worked as smoothly as possible in an uncertain world, given the often depressed financial conditions of both the railroads and the coal industry.

The consumers of coal also benefited markedly from this relationship. Fairly low rail rates, reasonably steady and consistent service, and low coal prices brought about by competition from other fuels such as natural gas, oil and, more recently, nuclear energy all combined to encourage the use of coal for the generation of electricity as the most cost efficient method. Into the late 1970's, some electric utilities were using coal to generate practically all of the electricity they produced.[3] Although these outside forces combined to keep coal from being a consistently profitable commodity for the producer and a panacea for the financial problems of the railroads, the relationship which evolved did keep the railroads in the coal business and did prevent the destruction of the coal

1. The Chessie System Railroads, major eastern haulers of coal moved 16,270,000 tons of coal, 2,377,000 tons of coke, and 6,771,000 tons of iron ore in 1981; 12,605,000 tons of coal, 2,146,000 tons of coke and 2,962,000 tons of iron ore in 1982, and 15,257,000 tons of coal; 3,081,000 tons of coke; and 5,711,000 tons of iron ore in 1983 (estimated). Norfolk Southern, another major hauler of coal, had 1983 revenues from coal in excess of $1,000,000,000. Much of this coal moves in easy-to-handle, unit trains, often with utility provided equipment. Increased Rates on Coal—Louisville & N. R.R., 362 I.C.C. 369, 411 (1979).

2. *See, e.g.*, Coal from Ky., Va., and W. Va. to Va., 308 I.C.C. 99 (1959); Coal from Ill., Ind., and Ky. to Ill. and Ind., 308 I.C.C. 673 (1959); Coal to New York Harbor Area, 311 I.C.C. 355 (1960). *But see N&W Railroad Learns Hard Lesson in Getting Along in Coal Country*, Wall St. J., Apr. 25, 1983, at 1, col. 6.

3. The Southern Electric System, one of the largest-investor owned electric utilities, encompassing parts of Georgia, Alabama, Mississippi and Florida, was 94% dependent on coal for fuel in 1978, with oil and gas supplying peak load energy only. Increased Rates on Coal, *supra* note 1 (verified statement of James Small).

industry, which aided power companies in their attempts to meet the growing demands of society for more low cost electricity.

During the 1970's, with the advent of the "energy crisis" and the dramatic price increases for competitive fuels, coal prices also rose substantially in compliance with economic law, and many coal producers were able to benefit handsomely, especially those which controlled the relatively "clean" coal demand by many users due to the environmental initiatives of recent times. Many producers and consumers began complaining to the Interstate Commerce Commission (ICC) that their sales and use of coal were constrained by unresponsive, slow rail service and asked for regulatory relief.[4] This increased demand also presented a major opportunity for the railroad industry, still reeling from the Penn Central fiasco and ever growing financial problems, to use coal as a vehicle for regaining reasonable profitability. Loosened regulation by the Commission, coupled with recognition by the Commission and Congress that the entire rail system could follow the northeastern railroads into bankruptcy if steps were not taken to increase revenues, gave the railroads a golden opportunity to increase coal rates by much higher percentages than the rate increases for most other commodities. Coal rate increases of up to forty percent were filed by various railroads,[5] and were justified to the ICC as being necessary to improve carrier profitability, to make coal pay its "fair share," and to enable the carriers to make improvements in service (new track, extra engines, etc.) necessary to meet the growing demand for coal transportation.[6] The recognition of railroad revenue needs, the strengthening market for coal, and the often "boom or bust" nature of the coal industry made these arguments attractive to the Commission, which began justifying coal rate increases on the grounds of overall railroad revenue needs and as being necessary to upgrade railroad operations to meet the increased demands of coal producers and users.[7]

Not surprisingly, this turn of events brought howls of protest from the coal industry, which had grown accustomed to stable coal transportation rates, or even rates that had been falling in real, inflation adjusted terms. As the transportation costs of some coal (especially that produced in the West) began exceeding the price paid the producer and as escalating

4. *See, e.g.*, Assigned Cars for Bituminous Coal Mines, 346 I.C.C. 327 (1974). In other instances, the ICC has ordered such equitable remedies as transferring locomotives from one carrier to an affiliated carrier in order to alleviate coal transportation problems.

5. *See, e.g.*, Increased Rates on Coal, *supra* note 1, (an unusually large, but pathbreaking case in which the railroad requested a 38% rate increase on all originated coal shipments).

6. *Id.* at 372-79, 400-03, 408-09, 429-30, 435-38, 439; Annual Volume Rates on Coal—Wyo. to Flint Creek, Ark., 361 I.C.C. 533 (1979). The capital incentive rate provisions also encouraged this argument. *See* 49 U.S.C. § 10729 (1982); Capital Incentive Rate Regulations, 361 I.C.C. 778 (1979).

7. Increased Rates on Coal, *supra* note 1, at 412-17.

transportation costs continued pushing up the delivered cost of coal, electric utilities and others with large fixed investments in coal burning generating facilities and access to only one source of transportation became very concerned about the high costs they were being forced to pass on to their customers and the possibility of seemingly endless future increases with no competitive checks in place. In effect, electric utilities, which price their product on the basis of cost plus reasonable return on investment, expected the same consideration from the regulated railroads and the ICC in their approach to railroad costs and rates. This traditional pricing policy eroded rapidly, much to the dismay of the power companies. Long-term coal supply constraints, coupled with the ICC's traditional refusal to allow users or producers to make binding long-term contract agreements with railroads (now reversed[8]), left the electric utilities without immediate weapons to combat the increases. They were locked into expensive plant sites and long-term coal supply agreements, with one mine contracted to produce coal for the facility. Their transportation alternatives were often inadequate or non-existent, but the sole transportation provider—the railroad—had power to alter rates, seemingly at will and unchecked by regulatory constraints.

For producers, the results were much the same, with those companies having access to only one railroad (and no alternatives, such as barges) often finding their competitive position weakened vis-a-vis their competitors who had access to transportation alternatives. No longer could a producer mine coal with the assurance that railroad rates would not put a particular mine or company at a competitive disadvantage in this very competitive market. Transportation had to be factored into the equation, but it was too late to do anything about contracts, agreements and investments that had been entered into before the railroads were given increased flexibility concerning coal rate increases. Clearly, the symbiotic relationship that existed for so long had fallen apart. Each element—user, producer, and transporter—still was dependent on the others, which muted much open hostility, but the degree of animosity and antagonism, not to mention law suits and other actions, appeared to reach new highs.[9]

In effect, the railroads, producers, and users had dramatically differing views of the role of a railroad in the coal business. For the producers and users, the railroad's role was seen as primarily passive. It should set its rates at a level which allowed for a reasonable return on its coal related investment and recoupment of all its coal related costs, including pro rata

8. *See* Change of Policy, Railroad Contract Rates, 43 Fed. Reg. 58,187 (1978) (codified at 49 C.F.R. pt. 1039).

9. In the early 1970's, the Southern Electric System participated in only two transportation-related law suits involving railroad rate levels. By the end of the 1970's, the average had become three per year by this author's estimate.

shares of overhead and so on. Once supply and demand for the overall market in question determined an equilibrium selling price for coal, individual producers were free to choose to provide coal at that price, based on whether production costs plus the set railroad rates were equal to or less than the delivered price at which the coal could be sold. While competitive economic theory suggests that, in the long run, all existing companies will end up at a position in which production costs plus transportation costs equal the equilibrium price of the commodity, the long run infrequently occurs.

In the short run, differences often exist between various companies. This could occur due to the company's location, the quality of its coal, its bargaining ability with labor or landowners, or any number of factors which lower its production costs in the short run below those of its competitors. This fortunate company would make an above average profit or economic surplus. Likewise, some coal companies will have higher production costs and will be able to participate in the coal market only if they are willing to accept a loss. Transportation costs remain basically the same for all similar companies, even though this means that some will choose not to ship coal and that others will make a substantial profit on their shipments. In this passive role, transportation costs represent a relatively fixed and constant component of the delivered price of coal. The railroad operates effectively risk-free, making a reasonable return (based on what is common for other industries) on all the coal it transports while the producer, which is not guaranteed a positive return, is free to benefit handsomely if it has been shrewd or to lose substantially if it has not been. The producer is the risk-taker and the recipient of "excess" profits if it could keep its costs below those of its competitors or produce a better product, while the railroad would receive a certain, but limited, profit on each haul.

The railroads, however, have now placed themselves in a much more active role. While their profit may be assured on individual movements, they argue that they still are harmed somewhat by the "bust" phase in a coal cycle and should benefit more from the "boom" phase, even though much coal now moves pursuant to minimum annual volumes in unit trains (which are immune from the "bust" cycle).[10] They have occasionally lowered rates in the past in an effort to keep the mines operating, and claim that they generally have kept coal rates at low levels.[11]

10. A "unit train" is a regularly scheduled movement in which the same cars continually shuttle between one destination and one origin carrying only one commodity. Often the cars are owned by the shipper rather than the railroad. A typical unit train might consist of 100 hopper cars, each carrying 100 tons of coal.

11. *See supra* note 2. Many railroads often note that in the past, coal rates have been raised by lower percentages than rates on other commodities during general increase proceed-

They have a larger stake in the coal industry than they do for most other commodities they haul, accept the risk of standing ready with massive investments in track and equipment to move whatever coal they are asked to transport, and therefore make less money when coal is economically unattractive and fails to meet expectations.[12] Thus, the railroads argue, it is only reasonable that they should share in the increased profits that accrue to the industry when times are good, and not be limited to a fixed, fairly modest rate of return on coal movements, especially as they believe that higher returns are necessary for coal traffic in order to compensate them for revenue shortfalls from other traffic which does not pay its full cost. To accomplish this, the railroads desire to charge profitable coal producers a higher than normal rate, thus absorbing some or all of the extra profit these producers would have been able to earn due to their above average efficiencies. The increased economic return that would have accrued to the owner of company due to its business acumen, or luck, would now belong to the railroad, leaving the company with a lower return, but still enough to stay in business.

Expressed slightly differently, this is market segmentation or the consumer surplus problem.[13] Referring to the graph below, let P_1 represent the price of any given commodity such as railroad services traditionally sold at a fixed price. Some users would be willing and able to pay more than is asked of them (D and E). Some others would not use the service if the charge were increased (F). Still others do not use it at all (G) because of its cost. In other words, various customers derive different benefits from the same service. They will use the service only so long as its benefits exceed its costs. If the price of rail services were increased from P_1 to P_2, D would still utilize the services, while E. F, and G would now find it unprofitable to do so. If the railroad were to lower its price to P_3, E and D would use its services, but the railroad would be giving up the right to charge D the higher price (P_2) that it would be willing to pay. In so doing,

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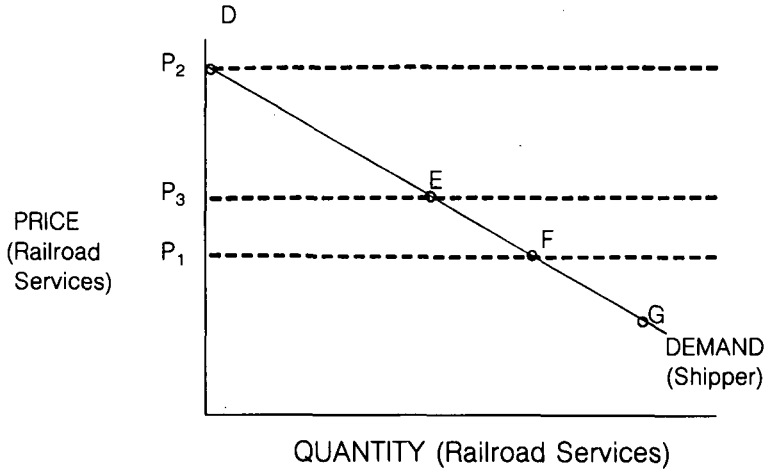
ings as justification for the claim that coal rates are "depressed." This begs the question whether the costs associated with transporting coal have gone up less than for other commodities (due to unit trains, customer provided equipment, and other innovations) during the same time period.

12. It will be interesting to see if this argument is valid in a depressed coal market. Will railroads have idled investment and lower profits? Will they lower transportation rates? The coal industry has been depressed for several years now and appears likely to remain so, with forecasted growth not being realized. At the present time, coal companies can produce 200 million tons annually more than they can sell. The forecasted annual 7% growth in sales to electric utilities has shrunk to less than 3%, steel purchases have fallen by over 50%, and export sales have dropped substantially. *Even If A Coal Strike is Averted, Industry Faces Major Problems*, Wall St. J., Aug. 22, 1984, at 1, col. 6.

13. More formally, the railroad uses the consumer's surplus to engage in second-degree price discrimination. *See, e.g.*, F. SCHERER, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE (2d ed. 1980).

the railroad would be giving up the revenue it could receive if it could tailor its prices to approximate the maximum each customer would pay. The total potential revenue the railroad is giving up when it charges P_1 is represented by the triangle P_1P_2F, and is often called the consumer surplus, or benefit that consumers receive from a service above what they are required to pay for that service. Businesses often try to capture that surplus for themselves by resorting to market segmentation—i.e., offering reduced fees to targeted persons and higher fees to other segments (business travelers versus tourists on airplanes) or by status symbols (polo ponies and alligators on shirt pockets versus plain pocket shirts made of precisely the same material).



When seen in the context of consumer surplus, the question confronting policy makers is whether railroads are passive entities which should accept a fairly fixed return on coal operations, or whether railroads should be able to attempt to capture some or all of the consumer surplus (the benefit that the railroad confers on the producer of coal beyond what the railroad routinely charges) when it exists. If railroads are allowed to capture some of this consumer surplus and, in effect, share in the good fortune or business skill of the coal producer or receiver, should the railroads also be required or expected to lower rates and return on investment from the producers and receivers when the consumer surplus no longer exists (i.e., coal prices are near production costs), as is currently the case?

Congress and the ICC have been grappling with these issues, although typically they have been expressed somewhat differently. For the most part, the arguments have focused on the amount of freedom

from regulation which should be given to railroads, especially when "captive" traffic is involved, and the definition of what traffic is actually captive to the railroads. The unstated assumption has been that additional rate freedom would give the railroads the ability to capture part of the consumer surplus, and that the railroads would act accordingly, thus eliminating many of their financial problems. In the remainder of this article, the decisions of Congress and the Commission relating to these issues will be analyzed and the implications of these decisions discussed.

While both Congress and the ICC have taken many actions during the past decade or so in an attempt to restore financial health to the ailing railroad industry, this article will focus solely on the principal actions that affect the carriers' ability to set rates in a flexible manner and potentially capture some or all of the available consumer surplus. Furthermore, this article will examine how these efforts have altered and may continue to alter the fortunes of industries that rely heavily on railroad transportation and are precluded, for a variety of reasons, from shifting to a competitive alternative. While several industries could fit into this category, large segments of the coal industry clearly do. As Congress and the ICC have singled out coal for special attention because of the possibility of abuse of railroad monopoly power due to the "captive" nature of this freight, the effects of the new legislative and regulatory policies on coal and coal transportation will be the centerpiece of this article.

II. LEGISLATIVE AND REGULATORY ACTIONS

In response to the new railroad provisions of the Railroad Revitalization and Regulatory Reform Act of 1976[14] (4R Act) and the Staggers Rail Act of 1980,[15] the ICC began allowing railroads much greater freedom to increase all of their potential revenues, but much of the controversy arising from these actions has centered around coal policy, specifically because of the captive shipper problem. While there have been many individual cases involving particular railroads, utility facilities, and coal producers, the ICC, in several recent major policy pronouncements, has set the course for coal transportation in this country for the foreseeable future—Ex Parte No. 353, *Adequacy of Railroad Revenue (1978 Determination)*;[16] Ex Parte No. 393, *Standards for Railroad Revenue Adequacy*;[17] Ex Parte No. 338, *Standards and Procedures for the Establishment of*

14. Railroad Revitalization and Regulatory Reform Act of 1976, Pub. L. No. 94-210, 90 Stat. 31 (codified as amended in scattered sections of 45, 49 U.S.C.).

15. Staggers Rail Act of 1980, Pub. L. No. 96-448, 94 Stat. 1895 (codified as amended in scattered sections of 45, 49 U.S.C.).

16. 362 I.C.C. 199 (1979).

17. 364 I.C.C. 803 (1981), *aff'd sub nom.* Bessemer & Lake Erie R.R. v. ICC, 691 F.2d 1104 (3d Cir. 1982), *cert. denied*, 103 S. Ct. 2463 (1983).

Adequate Railroad Revenue Levels;[18] Ex Parte No. 320 (Sub-No. 2), *Market Dominance Determinations and Consideration of Product Competition*;[19] Ex Parte No. 347 (Sub-No. 1), *Coal Rate Guidelines—Nationwide*;[20] Ex Parte No. 346 (Sub-No. 7), *Railroad Exemption—Export Coal*;[21] and Docket No. 38754, *Arkansas Power & Light Co., Petition to Institute Rulemaking Proceeding—Implementation of Long-Cannon Amendment to the Staggers Rail Act*.[22] In this section, the treatment of coal under these decisions and their underlying legislative provisions will be discussed.

A. Revenue Adequacy

1. Determining Revenue Adequacy

With passenger service and the Penn Central already burdening the taxpayers, and with it becoming increasingly clear that overregulation by the ICC had hamstrung railroad efforts to improve profitability and lower costs, Congress passed the 4R Act, a somewhat indecisive sounding measure, which appeared to loosen a few regulatory constraints on the railroads. For purposes of this paper, the Act's most important provision directed the ICC to aid the railroads in achieving revenue adequacy, which was defined as revenue:

> adequate, under honest, economical, and efficient management, to cover total operating expenses. . . . plus a fair, reasonable, and economic profit or return (or both) on capital in the business, (with such revenue levels to) provide a flow of net income plus depreciation adequate to support prudent capital outlays, assure the repayment of a reasonable level of debt, permit the raising of needed equity capital, . . . cover the efforts of inflation in amounts adequate to provide a sound transportation system in the United States.[23]

From this, it was clear that the revenue needs of railroads would take on increased prominence in ICC deliberations. This provision was tempered, however, by Congress's expressed concern that carriers not use the need for revenue adequacy as an excuse or rationale for obtaining monopoly profits from shippers and receivers which had no competitive transportation alternatives. One provision which showed this concern was the "market dominance" section of the Act, which maintained ICC jurisdiction over the reasonableness of rates in the "absence of effective

18. 358 I.C.C. 844 (1978), *aff'd as modified*, 359 I.C.C. 270 (1978).

19. 365 I.C.C. 118 (1981), *rev'd in part sub nom.* Western Coal Traffic League v. United States, 694 F.2d 378 (5th Cir. 1982), *cert. denied*, 104 S. Ct. 2160 (1984).

20. Coal Rate Guidelines—Nationwide (I.C.C. served Feb. 24, 1983) [hereinafter cited as Ex Parte No. 347].

21. 367 I.C.C. 570 (1983), *vacated sub nom.* Coal Exporters Ass'n v. United States, 745 F.2d 76 (1984), *cert. denied*, 105 S. Ct. 2151 (1985).

22. 365 I.C.C. 983 (1982).

23. 49 U.S.C. § 10701 (1982).

competition from other carriers or modes of transportation."[24] In effect, this provision was analogous to what an economist would call "inelastic demand for transportation services" and recognized that some shippers simply have no choice but to pay whatever price a carrier chooses to charge when there are no available competitive transportation sources and no products which can be substituted for the one that comes via rail. A wheat farmer in North Dakota, a coal mine, or an electric utility generating plant could be examples of "market dominant" traffic or "captive" shippers as defined by the Act. A nearby navigable river, trucking feasibility, or many other factors could, of course, vitiate the seemingly captive position of a given shipper.

The other crucial change espoused by the 4R Act was its reliance on competition, rather than ICC fiat, to set transportation policy whenever possible.[25] Given the record of the ICC, this change was understandable.[26] Section 207 gave the ICC authority to exempt railroad transportation or services from regulation if regulation would:

1. not be necessary to carry out transportation policy;
2. be an unreasonable burden on the railroads; and
3. serve little or no public purpose.[27]

Four years later, the Staggers Act amended this section by removing the requirement that the regulation serve little or no public purpose and that it be an unreasonable burden on a petitioner or on interstate or foreign commerce.[28] The ICC could then exempt railroads from any regulation, rule, practice, or policy which is found not to be necessary to carry out national transportation policy, as expressed by the Staggers Act. The legislative history of the Act singled out this exemption provision as the "cornerstone" of the Staggers Act.[29] Furthermore, the ICC was given the

24. 49 U.S.C. §§ 10701(a), 10709(a) (1982). Thus, in the absence of market dominance, carriers were free from regulatory constraints and could set rates in response to their perceptions of demand and market conditions. Bessemer & Lake Erie R.R. v. ICC, 691 F.2d 1104, 1108 (3d Cir. 1982), *cert. denied*, 103 S. Ct. 2463 (1983). *See also* Ford Motor Co. v. ICC, 714 F.2d 1157, 1158-59 (D.C. Cir. 1983).

25. 49 U.S.C. § 10505 (1982). Clearly the ICC possesses broad exemption power. American Trucking Ass'ns v. ICC, 656 F.2d 1115, 1118-21, 1127 (5th Cir. 1981). *See also* Simmons v. ICC, 697 F.2d 326 (D.C. Cir. 1982); McGinness v. ICC, 662 F.2d 853, 855-57 (D.C. Cir. 1981).

26. *See, e.g.*, Grain in Multiple-Car Shipments—River Crossings to the South, 318 I.C.C. 641 (1963); Grain in Multiple-Car Shipments—River Crossings to the South, 321 I.C.C. 582 (1963), *remanded sub nom.*, Cincinnati, N.O. & T.P. Ry. v. United States, 379 U.S. 642 (1965) (in which an interminable battle took place concerning whether railroads should be able to attract new business by using larger "Big John" covered hopper cars and offering lower rates than competing rail and barge lines. The lower rates were finally approved.)

27. Grain in Multiple-Car Shipments—River Crossings to the South, *supra* note 26.

28. 49 U.S.C. § 10505 (1982).

29. H.R. REP. No. 1035, 96th Cong., 2d Sess. 60, *reprinted in* 1980 U.S. CODE CONG. & AD. NEWS 3978, 4005.

responsibility of "actively pursuing exemptions"[30] and Congress stated that "as many as possible of the Commission's restrictions on changes in prices and services by rail carriers will be removed" through the use of the provision.[31] Still, this language was tempered with the requirement for the ICC to "adopt a policy of reviewing carrier action after the fact to correct abuses of market power."[32] Coal was singled out as needing protection during the debate, and was the only commodity so discussed.[33] Language was included in the record that the power to exempt traffic from regulation should not be used "at the expense of captive shippers who have no reasonable transportation alternatives"[34] and that coal should not be unduly burdened by ICC action, bearing only its fair share of railroad costs.[35]

Once Congress mandated the ICC to strive toward bringing the railroads to a state of revenue adequacy, it was incumbent on the Commission to determine what railroad revenue adequacy consisted of, and several proceedings did just that. The Commission concluded that the railroads should have an opportunity to earn a return on investment equal to the current cost of capital, and has then proceeded yearly in a very straightforward manner to determine the cost of capital for various railroads, now using the current, rather than embedded, before tax debt cost of each, and estimating the equity return that would be necessary for the railroads to attract needed new capital.[36] Comparisons of the equity return earned in other industries and by other regulated utilities were among the evidence introduced and relied on by the ICC.[37] In effect, the Commission determined the return required for the composite railroad to reach revenue adequacy in a manner very similar to that used by most state regulatory bodies to determine the revenue needs of an electric utility. While the Commission's determination in each proceeding varied somewhat based on the vagaries of changing economic conditions, ICC estimates of revenue adequacy initially determined the before tax debt cost of railroads to be in the 7% range and the equity cost to be 12-13%, with a weighting of between 35-40% debt and 60-65% equity.[38] These

30. *Id.*

31. H.R. REP. NO. 470, 96th Cong., 1st Sess. 105 (1980).

32. *Id.*

33. *See* S. REP. NO. 470, 96th Cong. 1st Sess. (1979).

34. *Id.* at 17.

35. *Id.*

36. *See generally* Standards for Railroad Revenue Adequacy, 364 I.C.C. 803, 814-16 (1981), *aff'd sub nom.* Bessemer & Lake Erie R.R. v. ICC, 691 F.2d 1104 (3d Cir. 1982), *cert. denied*, 103 S. Ct. 2463 (1983).

37. *Id.*

38. *See* Adequacy of Railroad Revenue (1978 Determination), 362 I.C.C. 199, 202, 256 (1979).

figures appear to be relatively modest and certainly are not out of touch with the economic realities of the late 1970's, the time frame on which these first estimated were based, except for the fact that not a single major railroad is "revenue adequate" pursuant to the present standard.[39]

Perhaps the most controversial methodological element is the use of current, rather than embedded, debt cost. This practice yields a windfall to the railroads. In times of rising interest rates, the determination would tend to overstate the cost of debt to the railroads because they owe many long term fixed obligations (bonds) which pay interest much lower than current levels. In effect, the railroads are allowed to earn a return on their debt obligations over and above the cost of servicing those instruments. This is contrary to the thinking of most regulatory bodies which recompense only for actual, embedded debt costs, and under current economic conditions tends to work against the interests of consumers and shippers. In the future, however, if interest rates begin falling below current levels, the policy could disfavor the railroads. This would occur if the embedded debt cost exceeds current market yields, an outcome that is not likely to happen in the near future, but one which certainly is not improbable.

The findings also were attacked by shippers on many other grounds, the most prominent being that the required revenue levels and returns on investment were higher than necessary to allow the railroads to attract capital and to be financially viable, that railroad earnings were understated due to ICC accounting practices, and that the rate base (or investment) of the railroads was overvalued due to large amounts of sunk investments that are obsolete, inefficient, and no longer revenue producing or needed, but which are still carried on railroad books.[40] In effect, the argument was that book value exceeds market value on quite a large percentage of railroad assets. As regulatory principles require that a company earn its capital return only on those assets that are "used and useful" (productive), large amounts of obsolete property reflected on railroad books could lead to an inflated rate base and the overstatement of railroad revenue needs.

The ICC rejected the inflated rate base argument on the ground that obsolete investment was less than one percent of the railroad rate base.[41] The Commission also pointed out the impracticality of the undertaking suggested by shippers in culling out unneeded railroad investments and noted that such second guessing of prior investment decisions could increase the risk of future railroad investments, thus leading to a higher

39. *See supra* note 36.

40. Ex Parte No. 347, *supra* note 20, at 15 n.43. *See also* Standards for Railroad Revenue Adequacy, *supra* note 36, at 830.

41. Ex Parte No. 347, *supra* note 20, at 15 n.43.

required return on capital.[42] The ICC suggested that such a policy could cause greater future rate increases if this increased regulatory investment risk offset revenue savings from the reduced rate base.[43] The final, rather vague point made by the ICC was that phasing in major rate increases for captive traffic would provide carriers with an incentive to eliminate unneeded facilities, although how this would occur remains unclear.[44]

For the most part, the general arguments of the shippers are not as persuasive as those of the ICC. First of all, many of the electric utilities which would bear the brunt of higher coal freight rates also are regulated, and routinely ask for large rate increases due to low return on equity, inflation, new construction, and so on, and are constantly in the position of arguing that their return on equity is not high enough to attract new capital. Electric utilities, for the most part, have in fact not been allowed to earn a sufficient return on equity, and neither have most railroads for quite a long period. It is somewhat unseemly, and perhaps inconsistent, for electric utilities to attack a finding that focuses on return on equity. After all, their regulatory bodies do precisely the same thing, although in a somewhat different manner, one less beneficial to the regulated entity. Certainly, the ICC left itself open to criticism and legal challenge because previous policies had considered these other factors,[45] but, in principle, a finding by a regulatory body that finally recognizes the need for the industry to earn a competitive yield on its investment is certainly not bad economics, even if adopted in a less than procedurally perfect manner and even if the consequences of such a finding have serious ramifications for coal burning utilities due to certain other ICC actions. Short-term procedural victories may appear desirable; but rather than complaining about the good fortune of the railroads in finally getting the ICC (and Congress) to recognize the financial realities and weaknesses of the national transportation system due to the fiscal plight of some railroads, perhaps the utilities would be well advised to expend their efforts by trying to restrain other ICC practices which cause financial distress to utilities and their rate payers and by getting state commissions to adopt an equally realistic approach. There are quite a few other issues on which the railroads and coal rate policy can legitimately be attacked without becoming bogged down in this one.

The issue of inflated rate base is a troubling one because it does

42. *Id.*

43. *Id.*

44. *Id.*

45. *See generally* Standards and Procedures for the Establishment of Adequate Railroad Revenue Levels, 358 I.C.C. 844 (1978). Standards for revenue adequacy found at 49 C.F.R. § 1109.25 (1980) were repealed, so that now the ICC will consider only the current cost of capital in its deliberations.

appear likely that the railroads control quite a few obsolete assets; then again, so do most large, capital intensive corporations. Technology, customer needs, population shifts, environmental concerns, and many other factors can quickly render obsolete or disfunctional investments that were properly made at an earlier time. Absent gross malfeasance in railroad investment policies, it would be inappropriate for the ICC to disallow railroads the ability to recoup their investment costs and a reasonable return on the basis of second-guessing or ex parte rationales about the desirability of certain prior decisions. Again, most electric utilities would expect (or hope for) the same policy from their regulatory agencies, especially given the problems facing the owners of nuclear power plants. Also, another reason why current market values may be less than book value, thus leading to an inflated railroad rate base, is the ICC regulatory policies which have kept some railroads on the brink of financial insolvency. Perhaps in a more enlightened regulatory environment, the market value of these assets would rise to or above book value as they become more productive, free from governmental interference in railroad decision-making. Thus, the decline in value may not be the sole responsibility of the railroads themselves, and they should not bear the financial brunt of earlier regulatory policies. Finally, as a practical matter, it is very difficult to ascertain those investments which are obsolete and for which a return should not be earned, with the only obvious candidates being that very small amount of railroad investment which is targeted by the railroads for abandonment each year.

It is not surprising that the utilities object to rulings such as those involving the use of current debt costs, which allow the railroads a much more favorable potential return than traditional regulatory principles would allow.[46] Certainly this practice is not necessary to allow the railroads a reasonable return on their fixed investment and should be tempered by the ICC or the railroads will be able to exceed true revenue adequacy at the expense of captive shippers, an outcome contrary to Congressional intent. The utilities only want railroads treated in a manner designed to

46. Other ICC proceedings which have also raised the ire of utilities and which do tend to overstate railroad revenue needs beyond accepted regulatory principles include Cost Standards for Railroad Rates, 364 I.C.C. 898 (1981) (which severely limited the number of railroad rates that could be found noncompensatory); Standards for Railroad Revenue Adequacy, *supra* note 36 (which suggested the use of current or replacement cost accounting in railroad revenue adequacy determinations, a move that would markedly increase railroad revenue needs); Alternative Methods of Accounting for Railroad Track Structures, 48 Fed. Reg. 7182 (codified at 49 C.F.R. pt. 1201) (inflation based accounting for all railroad property except land). An appeal of this decision is pending before the United States Court of Appeals for the District of Columbia. Other federal offices also seemed concerned that the ICC had gone too far in aiding the railroads. *See* U.S. GENERAL ACCOUNTING OFFICE, INFORMATION ON REGULATORY REFORM UNDER THE STAGGERS RAIL ACT OF 1980, at 7-10 (1983).

yield solely a reasonable return, and for this they certainly cannot be faulted. Still, however, on an overall basis, current ICC practices appear more likely to allow the railroads to systematically approach revenue adequacy then prior regulatory practices and in principle seem preferable. The problem is not with the procedures themselves, but rather with the ICC positions which short-circuit the Congressional safeguards concerning captive shippers.

2. *Achieving Revenue Adequacy*

The other major determination to come out of the revenue adequacy proceedings was the strong reaffirmation of differential pricing as a mechanism for allowing the railroads to reach revenue adequacy. Traditionally, regulatory policy requires that each customer pay rates equal to the costs associated with its service plus a fair return on equity to the carrier and that all customers pay roughly equivalent rates for roughly equivalent services. In the railroad area, this policy has led to the development of an archaic, highly intricate costing scheme which allows any interested parties to develop the variable costs (operating expenses) associated with an individual freight movement.[47] Variable cost plus an arbitrary Commission approved allowance for fixed (constant) costs or overhead was referred to as "fully allocated cost."[48] This number, expressed on a per ton basis, has often been the focal point for determining the reasonableness of a challenged rate. In effect, then, all rates were set as a function of fully allocated cost.

In theory, if each movement yields to the railroads' fully allocated cost plus a reasonable return, revenue adequacy would be reached. In practice, however, some traffic has competitive alternatives which are priced lower than railroads' fully allocated cost. The railroads must then reduce their rates or lose the business. If the competitive rate is below railroads' variable cost, economic theory suggests that the freight should not move via rail because it would be carried at an out-of-pocket loss to the railroad; if the freight can be hauled at a rate between fully allocated cost and variable cost, the railroad should compete for the freight. In this zone, the freight would pay all its associated out-of-pocket expenses, plus some (but not enough) of the overhead that the railroad needs to operate, leaving less overhead that must be provided by the remaining shippers. Assuming that all freight moves at above variable cost, but also assuming that some freight moves at below fully allocated cost plus a fair return, the

47. Ex Parte No. 347, *supra* note 20, at 8. *See generally* Cost Standards for Railroad Rates, 364 I.C.C. 898 (1981).

48. Cost Standards for Railroad Rates, 364 I.C.C. 898 (1981).

policy question is what shippers will have to make up the difference, and in what proportion.

In its efforts to end this shortfall, the ICC scrapped its usual comparable rates and fully allocated cost plus a reasonable return scheme in recognition that this method was unlikely ever to yield revenue adequacy to the railroads due to the massive amounts of freight that moved at below fully allocated cost because of competitive conditions.[49] Any method of arbitrarily assigning overhead to all freight would drive off the freight for which competitive alternative existed, thus increasing the woes of the carriers and the amount of fixed costs that the remaining shippers would eventually be forced to shoulder. The answer to this quandary seized on by the Commission was deceptively simple and, in reality, was the only one available to it—differential pricing, a concept that Congress had already included in the Staggers Act for setting certain jurisdictional levels.

Differential pricing is simply another slightly less onerous name for "value of service" or "what the market will bear," and allows railroads to capture as much of the consumer surplus as possible. Rather than basing rates on cost to the railroad plus a reasonable return, railroad rates should now be based, according to the ICC, on what the shipper would be willing to pay for the service, i.e., a rate up to, but not more than, the value or benefit the shipper receives from the transportation provided by the railroad. For shippers with transportation alternatives, the rate would be relatively low (below fully allocated cost), and for shippers which have a need for transportation that can be accomplished only via rail (coal users), the value of service provided may be very high. The regulatory dilemma is how to allocate the railroad fixed costs to shippers of commodities such as coal and wheat, for which even the shippers would admit the benefits derived from good rail service are substantial, without allowing the railroads to set the rates unreasonably high through the use of their monopoly or market dominant position. This dilemma led to the need for a proceeding to examine the entire issue of the share of fixed costs to be shouldered by coal, and how that share should be determined. Ex Parte No. 347 (Sub-No. 1), *Coal Rate Guidelines—Nationwide*[50] became that proceeding.

B. Market Dominance

For the most part, the 4R Act and the Staggers Act removed from the ICC authority to find a rail rate unreasonably high if the forces of free and open competition could ensure that the railroads could not exercise mo-

49. Ex Parte No. 347, *supra* note 20, at 8-9.

50. *Id.*

nopoly power over the shipper.[51] On the competitive traffic, the removal of ICC control over maximum rate levels meant that carriers were free "to set rates in response to their perception of market conditions."[52] For shippers of commodities that could be transported via truck, or for shippers having access to barge lines or multiple railroads, competition was expected to suffice to control potential railroad abuses. For the captive shipper of bulk commodities, such as a coal producer which has access to only one railroad, the "market dominance" provisions were supposed to offer access to regulation as a substitute for competition. In order to more specially protect these captive shippers, the Long-Cannon Amendment[53] to the Staggers Act was designed to limit the ability of carriers to force their market dominant traffic to subsidize competitive freight and to allocate fairly any unavoidable railroad revenue shortfalls. Differential pricing was still an acceptable ICC technique for encouraging revenue adequacy, but the Amendment's function was to ensure that captive shippers did not bear a "disproportionate share of responsibility" for improving railroads' financial position or did not "subsidize the continuation of antiquated and inefficient railroad practices."[54]

Even to be a candidate for market dominance, however, the traffic in question must move at a rate greater than or equal to 175% of variable cost.[55] In the event this test is satisfied, the Commission still does not have to temper the rate, or even investigate it. Its decision to investigate a rate over which it has jurisdiction is based on:

i. The amount of traffic which is transported at revenues which do not contribute to going concern value and efforts made to minimize such traffic
ii. The amount of traffic which contributes only marginally to fixed costs and the extent to which, if any, rates on such traffic can be changed to maximize the revenues from such traffic; and
iii. The impact of the proposed rate or rate increase on the attainment of the national energy goals and the rail transportation policy under section 10101(a) [National Transportation Policy] of this title, taking into account the railroad's role as a primary source of energy transportation and the need for a sound rail transportation system in accordance with the revenue adequacy goals of section 10704 of the title.[56]

If, after due consideration of these three factors, the Commission decides to investigate a rate, or if, in response to a complaint filed by a

51. 49 U.S.C. § 10709(c) (1982).
52. *Bessemer*, 691 F.2d at 1108. *See also Ford Motor Co.*, 714 F.2d at 1158-59.
53. 49 U.S.C. § 10707a(e)(2)(B)-(C) (1982).
54. Arkansas Power & Light Co., Petition to Institute Rulemaking Proceeding—Implementation of Long-Cannon Amendment to the Staggers Rail Act, 365 I.C.C. 983, 988 (1982). *See also* 125 CONG. REC. 36,421-22 (1979); 126 CONG. REC. 7264-67 (1980) (remarks of Sens. Long, Cannon, Baucus and Bentsen).
55. 49 U.S.C. § 10707a(e)(2)(A) (1982).
56. 49 U.S.C. § 10707a(e)(2)(B) (1982).

shipper, chooses to examine the rate, it should base its judgment on factors (i) and (ii) above—railroad efforts to minimize traffic moving at below variable cost and to maximize revenues from traffic moving at less than fully allocated cost.[57] Furthermore, the ICC must consider whether the commodity subject to the rate is paying an unreasonable share of the railroad's overall revenues.[58] If the ICC acts pursuant to a complaint, the shippers bear the burden of proof.[59] No burden is specified concerning the proceedings involving the ICC's decision to institute an investigation.

While this procedure appears straightforward, if somewhat convoluted, the ICC does not appear to have taken its obligations concerning market dominance, captive traffic, and the purposes of the Long-Cannon Amendment very seriously. Rather than institute a rulemaking proceeding to determine those factors and other evidence necessary to conduct a Long-Cannon inquiry, the Commission decided to consider the issue on a case by case basis.[60] It did set forth its burden of proof guidelines for Long-Cannon proceedings, however, with the burden being placed on shippers to demonstrate railroad inefficiencies and that the removal of these inefficiencies alone would lead to railroad revenue adequacy.[61] In its ad hoc Long-Cannon efforts, the ICC has been surprisingly unwilling to require railroads to systematically produce evidence concerning elasticities of demand for various traffic, a necessary prerequisite to determining what more the railroads could do to maximize revenues from non-captive traffic.[62] The Commission has also been very unsupportive of discovery efforts by shippers, an especially large problem when only the railroads have cost data for all their freight, which are a necessity if comparisons are to be made; therefore, only railroads have data to show their own efficiencies and inefficiencies.[63]

Refusal to allow adequate discovery, short timetables to analyze the data, and failure to require the railroads to provide data on costs of serving various commodities (some captive, some not), coupled with the burden of proof on the shippers, yields an impossible task for a company trying to avail itself of the Long-Cannon protections. ICC decisions have set up a perfect "stonewall" situation for the railroads. Their failure to provide adequate costing data or elasticity studies precludes a shipper

57. 49 U.S.C. § 10707a(e)(2)(C) (1982).
58. *Id.*
59. 49 U.S.C. § 10701a(b)(2)(A) (1982). If the ICC institutes an investigation on its own motion into the reasonableness of a rate, the carrier bears the burdens of proof. 49 U.S.C. § 10701a(b)(2)(B) (1982). The statute does not impose a burden of proof or production concerning ICC determinations of whether to investigate a proposed rate.
60. *Arkansas Power & Light Co.*, 365 I.C.C. at 991, 993.
61. *Id.*
62. *Id.* at 997.
63. *Id.*

from proving its case, and this lack of data cannot even be used to show that the railroads are operating inefficiently. In effect, the ICC has set up a system where a railroad benefits from its failure to know its costs, from its lack of procedures to maximize revenues from non-profitable freight and to minimize inefficiencies, and from its lack of a systemtic approach for treating captive traffic in a manner which minimizes the burden on the traffic consistent with moving toward revenue adequacy. Most modern companies would be said to be mismanaged and inefficient per se if they did not have such systems in place, but ICC policies actually encourage such tendencies, even in the face of substantially expressed Congressional intent that railroads should be free to move toward revenue adequacy at the expense of captive traffic only if they are attempting to ferret out inefficiencies and revenue shortfalls to the extent possible from their other operations.

C. COAL RATE GUIDELINES

As its attempt to deal with situations in which railroads exercise market dominance over coal traffic and to develop a formula for prescribing maximum reasonable rates on such traffic, the ICC issued Ex Parte No. 347 (Sub-No. 1), *Coal Rate Guidelines—Nationwide*,[64] a series of nonbinding proposals. Not surprisingly, the Commission placed great emphasis on the goal of aiding the railroads in achieving revenue adequacy while paying very little attention to the other regulatory goal of not allowing railroads the unfettered opportunity to trample on the rights of shippers with captive traffic. In effect, the question was how the ICC could allocate excess railroad fixed costs among those shippers which have no competitive alternatives at the rate currently assessed by the carriers. When grappling with the issue, the ICC decided that any arbitrary method of allocating or attributing costs to the various shipper classes left the railroads with a revenue shortfall. Neither the ICC nor the railroads could possibly come up with a system to allocate the excess costs in an equitable manner that would not have the effect of driving some freight to competing modes, thus perpetuating the shortfall. The ICC, therefore, was left with some form of demand based on differential pricing as the only viable alternative. The question, then, became one of setting an upper limit on those rates which "are set in an essentially non-competitive environment,"[65] i.e., market dominant freight.

The railroads' position was that the only way to allow them to reach revenue adequacy and to minimize regulatory intrusions into their industry was "Ramsey Pricing," a theoretical system which uses demand elastici-

64. Ex Parte No. 347, *supra* note 20.
65. *Id.* at 9.

ties to determine what the market will bear for a particular movement and to charge accordingly.[66] Ramsey Pricing is a perfectly acceptable pricing method for the situation in which marginal costs are less than average costs, the typical railroad position, but it has no equitable component which takes monopoly power or captive freight into account as Congress has required. In effect, pure Ramsey Pricing would allow, and expect, unlimited rates to be charged to captive shippers, with the only upward constraint being a point where the shippers were forced out of business due to high rates or when the rates became so burdensome that another alternative mode became cost effective. This failure to set a maximum upper bound for captive traffic is the failure of theoretical Ramsey Pricing for use as a public policy tool when the carrier does not face competition from another railroad or another transportation mode. In effect, the Ramsey Pricing model assumes that competition is available for all freight or that there is nothing undesirable about charging limitlessly high rates to those without competitive alternatives. This is a position that may lead to theoretical economic efficiency but which was rejected by Congress.

Most shippers, on the other hand, recognized that some form of differential pricing, coupled with agressive pricing of competitive traffic, was necessary to nudge the railroads toward revenue adequacy, and that solely cost based pricing was no longer an adequate regulatory tool.[67] These shippers proposed a variety of plans, some of which would allocate the railroad revenue shortfall among the various classes of shippers which could bear an additional burden without defecting to other transportation modes.[68] These allocations, of course, were very difficult to define properly and could lead to unexpected defections of some freight and revenue shortfalls, if improperly implemented. Other proposals suggested setting ceiling rate levels at a percentage of variable cost, unless the carriers could prove the freight should bear an additional burden; some shippers proposed that the maximum allowable rate should be based on return on investment.[69] For instance, railroads would be allowed to earn twice the rate of return found necessary by the Commission to achieve revenue adequacy, but rates beyond that would be constrained by the Congressional principles relating to captive shippers and market dominance.[70] The shippers' proposals differed, but all had one goal in common—put some sort of cap on railroad rates that retained some semblance of cost based pricing (plus a profit additive). The maximum rate might yield revenue well in excess of fully allocated cost, but at

66. *Id.* at 9-10, 26.
67. *Id.* at 20-27.
68. *Id.*
69. *Id.* at 24-25.
70. *Id.*

least the railroads' ability to demand greater revenues from captive coal would not be unlimited.

The Commission rejected the shipper proposals as being arbitrary allocations (which they were, although they may also have been reasonable), impractical, likely to stifle innovation (an amazing statement to make in the context of railroads), or not likely to induce railroad revenue adequacy.[71] The ICC also rejected Ramsey Pricing, not in theory but on the practical grounds that large amounts of theoretical data of arguable validity (demand elasticities and marginal costs) would be needed to properly Ramsey Price and that requiring such data would not be in keeping with the Congressional mandate to trim the regulatory burden on railroads whenever possible.[72] Instead, the Commission accepted "stand alone" pricing and made it the centerpiece of a concept dubbed "Constrained Market Pricing."[73] Stand alone pricing had been advocated by some railroads and was consistent with the principles of Ramsey Pricing. The maximum allowable rate levels under the two systems were, for all practical purposes, likely to be little different.

1. *Constrained Market Pricing*

a. *Stand Alone Cost*

The ICC set forth four principles of Constrained Market Pricing, with the provision that a carrier violating any of the four *could* be found to be charging an unreasonably high rate.[74] Stand Alone Cost, the centerpiece of this scheme, was defined as the cost to the railroad of providing service solely to that single shipper.[75] In other words, the Stand Alone Rate was that rate at which a shipper could provide itself with a transportation alternative to the monopoly railroad at current prices. As the ICC correctly and rather obviously pointed out, "no shipper would reasonably agree to pay more to a railroad for transportation than it would cost to produce in isolation itself, or more than it would cost a competitor of the railroad to provide the service for it."[76] The ICC also stated that "no shipper could be said to be cross-subsidizing other shippers if it pays no more than the cost to the railroad of providing service dedicated solely to it."[77] In effect, then, Stand Alone Pricing stated that a rate was reasonable so long as it was less than the next most cost effective hypothetical alternative avail-

71. *Id.* at 20-27.
72. *Id.* at 9-10, 26.
73. *Id.* at 10-19.
74. *Id.* at 11.
75. *Id.*
76. *Id.*
77. *Id.*

able to the captive shipper, or was no more than the rate at which the railroad would lose its monopoly position over the traffic.

The problem with this position is clear. It is using a competitive economic model in a non-competitive situation. Transportation alternatives, if they exist, keep the cost to shippers at efficient, reasonable levels, and that is the rationale for deregulating those commodities and routes for which competition exists. Where competition does not exist, it is unreasonable to define maximum rate levels on the basis that nonexistent competition will keep them reasonable. Despite the mandate of Congress for the ICC to offer some protection for captive shippers, the Commission has in effect adopted the same test for both captive and non-captive shippers—an unrestrained "what the market will bear." The only limit on captive coal shippers set by the ICC under this test would be that railroads may not charge more than the best available potential alternative (such as building a new railroad or a coal slurry pipeline to serve that one shipper). In reality, the railroad could never charge more than the Stand Alone Rate regardless of ICC sanctions, because that is the rate level which would force the shippers to another carrier or transportation mode. Congress meant to provide some protection for captive shippers beyond what the market for captive freight will bear and clearly this test provides no such protection. It is inconceivable that Congress meant that the common carrier could charge a captive shipper any rate equal to or less than that at which it would be cheaper for the shipper to build its own private railroad for its exclusive use, but that is the interpretation of Congress's intent adopted by the ICC. The amount of protection is negligible to non-existent. The ICC's own administrative law judges have recognized the absurdity of this approach and in one case, a Judge pointed out that since passage of the Staggers Act the ICC has never found a rate to be above a maximum reasonable level.[78] It probably never will, for the level set by the ICC as possibly unreasonable (i.e., above Stand Alone Cost) is so high that no railroad could ever charge such a rate. Thus, this factor will never come into play.

b. *Railroad Management*

The second principle of Constrained Market Pricing focuses on management factors. In keeping with the Long-Cannon mandates, the ICC states that it will consider the amount of traffic which does not contribute to the going concern value of the railroad and efforts to minimize this traffic, the amount that only marginally contributes toward fixed costs and the extent to which such rates can be raised, and, finally, whether one com-

78. *See* Consumers Power Co. v. Norfolk & W. Ry., No. 37854S, at 9-10 (I.C.C. served Jan. 18, 1984) (Hopkins, A.L.J.).

modity is paying an unreasonable share of the carrier's overall revenues.[79] The ICC further vows to take action if carriers are "consciously carrying freight at a loss or at a suboptimal level,"[80] but in reality the lack of cost data and the lack of concern by the ICC for the lack of cost data make it highly unlikely that a shipper could demonstrate that a railroad is "consciously" carrying freight at a loss. The ICC simply believes that its system will automatically "induce railroad management to continue efforts to maximize revenues on all traffic,"[81] a highly dubious assumption given the paucity of regulatory incentives, the railroads' performance to date with non-captive traffic, and evidence in other cases that railroads do in fact carry large amounts of freight at an out-of-pocket loss.[82] Finally, the ICC states that any carrier failing "to conform to generally accepted standards of honest, economic, and efficient management' must bear the cost of the inefficiencies, not the captive shippers.[83] Again, the lack of data, the unavailability of discovery, and the short procedural time periods involved, coupled with the ICC's stated reliance on Constrained Market Pricing to force the railroads to act properly, suggest that only in the most egregious, almost fraudulent type situation could a shipper expect a carrier or the ICC to lower captive coal rates in response to management factors, or even to consider them, despite Congressional intent to the contrary.

c. *Revenue Adequacy*

The third part of the Commission's Constrained Market Pricing system has to do with changes in the system once railroads attain revenue adequacy. Although the ICC states that captive coal revenues which allow a railroad to attain or exceed revenue adequacy, as defined by the Commission, would not be unreasonable per se, these rates must be scrutinized more closely.[84] The ICC, however, takes a long-run perspective, so that rates will not have to be continuously adjusted if revenues slightly exceed or temporarily drop below revenue adequacy levels.[85] Because of the possible disincentive on carrier attempts to maximize profitability and improve efficiency, the Commission is not likely to lower

79. Ex Parte No. 347, *supra* note 20, at 15 n.43.

80. *Id.* at 14.

81. *Id.*

82. Potomac Elec. Power Co. v. Consolidated Rail Corp., No. 36111, at 14 (I.C.C. served Mar. 3, 1981) (showing that Conrail had below cost traffic of approximately $277 million in 1978, up from $117 million in 1977). The Louisville and Nashville Railroad apparently has very little idea what its costs are, making it rather difficult to compute the amount of below cost freight. *See generally* Petition of Louisville and Nashville Railroad Company for Review of a Decision of the Public Service Commission of Indiana Pursuant to 49 U.S.C. 11501, 367 I.C.C. 639 (1983).

83. Ex Parte No. 347, *supra* note 20, at 14.

84. *Id.* at 14, 15.

85. *Id.* at 15, 16.

captive coal rates if revenue adequacy is exceeded due to improved profitability on competitive traffic or better operational efficiency.[86] Only in the instance in which "a consistent pattern of return substantially in excess of carrier's revenue needs has been established . . . would [the ICC] . . . consider the reasonableness of rates on captive coal traffic and prescribe lower rates in appropriate circumstances."[87] The Commission further states, however, that this will be done only upon filing of a complaint, thus putting the burden of proof on the shippers, not on the carrier which has exceeded revenue adequacy by charging "stand alone" rates to captive shippers of coal.[88]

While this provision seems to offer some slight hope to the captive shippers that Stand Alone Pricing will not endure indefinitely, the practicalities associated with the provision are much more revealing and much less optimistic. First of all, revenue adequacy has been defined so that no major railroad currently can be said to have adequate revenues, and it appears unlikely that any will achieve this ICC nirvana in the near future. The Commission figured that if 1981 net investment and expenses remain constant, as do non-coal revenues, and coal rates grow at a uniform rate compounded annually, 17 of 21 major coal hauling railroads could reach revenue adequacy within 7 years if coal revenue grows 15% per year.[89] This represents a highly unlikely scenario, given the ups and downs of the coal industry, and the heroic assertions that net investment base and expenses will remain constant at 1981 levels. Furthermore, each year the ICC seems to increase the return needed for the railroads to reach revenue adequacy.[90] In all likelihood, revenue adequacy is going to be a very long-run proposition.

Even if such a state is reached, the captive shipper still has to show that the phenomenon of railroad adequacy is permanent in duration and is not due to railroad improvements in efficiency.[91] Again, it appears doubtful that much relief will be available to the captive shippers from this provision. Another problem is that revenue adequacy is based on return for book investment, a concept which is often meaningless in financial markets, which value a railroad on its earnings per share. To the extent that railroads can keep their return on book investment below revenue adequacy levels by keeping unused assets on the books, rather than aban-

86. *Id.* at 16.

87. *Id.*

88. *Id.*

89. *Id.* at 17-18 and app. D.

90. The railroads figured their composite cost of capital at 15.7%, with equity costing 17.4%, and debt 11.3% for 1983. In 1978, the ICC found a 10.6% overall cost of capital to be reasonable. Adequacy of Railroad Revenue (1978 Determination), 361 I.C.C. 79, 108 (1978).

91. Ex Parte No. 347, *supra* note 20, at 15, 16.

doning them or writing them off, they can continue to earn a very handsome return on these assets *ad infinitum* at the expense of captive shippers. Meanwhile, their earnings per share, stock prices and bond ratings could soar without ever attaining ICC standards for revenue adequacy. Clearly, the Commission needs to examine factors other than book revenue adequacy when determining the financial viability of the railroads. Growth in earnings per share would be a good place to start.

Finally, this use of revenue adequacy for individual railroads raises the spectre that some coal companies will be penalized with very high captive coal rates simply because the railroad that serves them is not as efficient or adaptable to changing conditions as others. For instance, if efficient railroad A attains revenue adequacy while inefficient railroad B does not, captive coal shippers on railroad B could see their rates continue to escalate indefinitely, while those on Railroad A could moderate somewhat. This situation could put B's shippers in a precipitous financial and competitive position, simply because of the random chance of their location on B's lines. If the Commission is to rely on revenue adequacy, it should do it on an overall basis for all major railroads, with the possible exception of Conrail, so that once the coal railroads as a whole had attained revenue adequacy, the protections from railroad market dominant pricing would be available to all captive shippers. In this manner, the railroads would have an incentive to strive for maximum efficiency because those failing to do so would be denied access to monopoly profits from captive coal before they attained revenue adequacy and those doing so could reap the benefits of monopoly pricing for a longer time. Another possibility would be to allocate the responsibility for non-regulated non-compensatory traffic to the railroads' shareholders, thus giving the railroads an incentive to minimize nonprofitable, competitive freight, an incentive sorely lacking in present ICC proposals.

d. *Phasing of Rate Increases*

Because of the ICC's concern that "dramatic" changes could disrupt coal markets, it proposed to phase in rate increases by generally not allowing rates to increase by more than fifteen percent per year plus an allowance for inflationary effects.[92] Thus, the *real* increase in coal rates could not exceed fifteen percent per year, except in unusual circumstances such as imminent bankruptcy or inability to meet debt service. The rates on coal would be presumed reasonable so long as the cumulative increase did not exceed fifteen percent, thus allowing an increase to be deferred for several years and then added on to the increase for a later

92. *Id.* at 16-18.

year without violating guidelines.[93] Rates on new traffic would be presumed reasonable if they do not exceed those for comparable movements, including the cumulative fifteen percent increase.[94] This allowable fifteen percent increase was to be inclusive of the zone of rate flexibility allowed by the Staggers Act for all traffic.[95]

The ICC based this requirement on the grounds that severe dislocations could occur if dramatic transportation cost increases were allowed.[96] Fears were expressed of precipitous rises in rates paid by consumers of electricity and of possible hasty conversions of coal burning power plants to alternative fuels, an occurrence that could be contrary to national energy policy.[97] Concern about forcing the railroads to attain the maximum possible contribution from all non-market dominant traffic also led to this provision, as did the rationale of allowing captive shippers time to evaluate their transportation alternatives and attempt to use this transition period to limit potential rate increases in any manner still available to them.[98] The Commission also suggested that, for a variety of reasons, electric utilities would be less captive to a single railroad and have greater market strength starting about 1986.[99] Finally, the Commission believed that most railroads were close enough to revenue adequacy that it could be reached within a reasonably short time, so that the transition period to total Stand Alone Pricing should not unduly affect their attempts to achieve financial strength.[100] The transition period, then, should allow for a smoother, less disruptive change to market oriented pricing, at least in the Commission's view, and should not excessively prolong railroad attempts at achieving revenue adequacy.[101]

Clearly, this is the only one of the four components of Constrained Market Pricing that offers any immediate protection to captive shippers. This protection is relatively modest, and may often be nonexistent in practice because even if the Commission's rosy scenario concerning revenue adequacy is true, it will still be eight years before most of the nation's coal haulers will have achieved revenue adequacy. In that time, coal rates may have tripled, *in real terms*. The effects of inflation, new investment, and so on will have driven up the potential rates charged to captive shippers even more. A tripling of real rates in eight years for captive shippers

93. *Id.* at 16 n.46.
94. *Id.* at 16.
95. *Id.* at 16 n.46.
96. *Id.* at 16, 17.
97. *Id.* at 17.
98. *Id.*
99. *Id.*
100. *Id.* at 17-18.
101. *Id.* at 16-18.

hardly seems indicative of any concern on the part of the ICC about protecting these users from the monopoly power of the railroads.

D. EXPORT COAL

In Ex Parte No. 346 (Sub-No. 7), *Railroad Exemption—Export Coal*,[102] the Commission exempted all export coal from any ICC rate regulation. In order to do this, the ICC first had to determine that regulation of export coal was not necessary to carry out national transportation policy. The analysis of this issue was extensive, but not really revealing or interesting.[103] The salient part of the order dealt with another criterion for exemption—whether the transaction was of limited scope or whether regulation was not necessary to protect shippers from abuse of railroads' market power.[104] In this proceeding, the Commission clearly and unequivocally stated its premise that the railroads should be allowed to capture as much of a shipper's consumer surplus as possible, and the railroads were actually in competition with the shippers to control as much of this excess or economic rent as possible. In other words, the ICC's regulatory position was that a railroad should no longer seek to earn a reasonable profit on each shipment and act as a common carrier, treating all shippers equitably and fairly; rather, the carrier was encouraged to take an active role, charging one customer more than a similarly situated competing shipper if the first shipper, by means of its efficiency, ingenuity or luck has managed to produce its coal for a price that yields to it a higher than average profit.

While opponents of this exemption argued that the railroads would price their services excessively high so that United States coal would not be competitive worldwide on a delivered basis,[105] the ICC and the railroads noted that this eventually would not be in the best interest of the railroads because of the large amount of capital the railroads have invested in export coal facilities, which would be unused, and thus unproductive, if American coal was priced too high for the world market.[106] Also, they believed that coal exporters have bargaining leverage with the railroads which could act as a check to keep rates reasonable, thus preventing the railroads from capturing all the consumer surplus associated with the coal transportation.[107] One reason for this would be that coal exporters tend to be larger producers and often own several mines,

102. Railroad Exemption—Export Coal, 367 I.C.C. 570 (1983), *vacated sub nom.* Coal Exporters Ass'n v. United States, 745 F.2d 76 (1984), *cert. denied*, 105 S. Ct. 2151 (1985).
103. *Id.* at 584-92.
104. *Id.* at 592-96.
105. *Id.* at 592.
106. *Id.* at 593-94.
107. *Id.*

located on more than one railroad, and are able to play one railroad against the other by threatening simply to shift production to another mine, thereby depriving that railroad of all revenues, unless a mutually acceptable transportation price is reached.[108] The ICC further noted that the exemption would terminate all antitrust immunity and that the railroads would not abuse their market position, even if able to, because the Commission might revoke its exemption decision and restore regulation of export coal.[109] The ICC concluded by arguing that:

> the exemption of export coal will place the parties involved in exporting coal on equal footing, and will leave the producer and carrier free to negotiate a division of available profit or economic rent. We expect that, following exemption, the railroads will differentiate among the mines they serve and set their rates in an area between an individual mine's long run marginal cost of extraction at the current cost of capital and the world market price. The railroads have long differentiated their rates among the mines they serve and are fully equipped to do so once regulation ends. Although, under exemption, the railroads sometimes may obtain more of the available profit than they currently do, it is in the carriers' long range self interest to encourage the shippers to expand production. Both they and the shippers have a common interest in bringing to market as much coal as the market will absorb. Regional and world competition and shipper transportation and marketing alternatives, as well as the carriers rational self interest, will all constrain the railroads from abusing such market power as they may possess . . . .[110]

The revealing statement makes perfectly clear the ICC's perception of how railroads should react toward both captive and non-captive traffic. Basically, the ICC hopes for an economic tug-of-war, with the railroads and shippers utilizing their long-run marginal cost curves in an effort to arrive at a mutually agreeable location. If, for instance, the delivered price of coal (set by the market) is $55.00 per ton, barge and transloading costs are fixed at $10.00 per ton, railroad variable costs are $8.00 per ton, and marginal coal production costs are $30.00 per ton, the ICC foresees railroads and producers haggling and negotiating over the economic surplus inherent in this transaction—$7.00 per ton. The producer would shut down before paying the railroad more than $15.00 per ton; the railroad would not consider hauling the coal for less than $8.00 per ton, but within those parameters, the ICC desires that economic leverage, bargaining power, negotiating skills or threats, and other similar factors should set the transportation rate. A $15.00 per ton rate would allow the railroad to capture the entire consumer surplus associated with the haul;

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108. *Id.* at 594.

109. *Id.* at 595.

110. *Id.* at 595. *But see* S. REP. NO. 470, 96th Cong., 1st Sess. 43 (1979) and H.R. REP. NO. 1430, 96th Cong., 2d Sess. 88 *reprinted in* 1980 U.S. CODE CONG. & AD. NEWS 4110 (1980) (indications that the exemption power should not be used at the expense of captive shippers, whether domestic or export shipments are involved).

an $8.00 rate would leave the entire surplus for the producer and keep the railroad in a state of revenue inadequacy. The only unanswered question is where within this range will the transportation rate ultimately be set, once the economic shootout has ended and the dust has settled. In the absence of meaningful competition, however, the ultimate result is starkly clear—if the shippers have no transportation alternatives, the transportation rate will hover close to $15.00, with the only variable being the accuracy of railroad cost estimates for producers and their perception of the strength of the coal market. Quite simply, the consumer surplus is theirs for the asking.

III. Analysis and Conclusions

Certainly, the ICC's unfettered non-passive, price differentiating (or discriminating), quasi-monopolistic role for the railroads is one view of the way to promote railroad revenue adequacy and allegedly protect the interests of captive shippers—and, as it has been advanced by the ICC and the railroads, it is a very important interpretation of their role. The policy question, however, is whether the ICC is on the right track. Most people involved with the issue recognize the railroads' need for greater freedom and applaud any reasonable regulatory policy that moves in the direction of fewer regulatory constraints. The remaining issue is simply whether the ICC has or has not given enough protection to shippers of a limited number of generally captive commodities. Even looking at a relatively captive commodity such as coal, only about half the shipments have no competitive alternatives.[111] The number of captive shipments may be relatively few, but the amounts of money they involve can be staggering.[112] Do these captive shippers need some protection from the railroads in order for equity to prevail and has the ICC met this need within the context of accomplishing other regulatory goals such as pushing the railroads toward a position of revenue adequacy?

While the ICC may have engaged in good long-run economic theory in developing its Constrained Market Pricing system for the purpose of achieving revenue adequacy, efficient economics do not always make good public policy. In this instance, they appear to be colliding. The ICC

111. Ex Parte No. 347, *supra* note 20, at app. B. A consulting firm for the ICC found that 53% of the utilities surveyed only have access to a single terminating carrier and are presently constrained from shifting to alternative coal sources. Utility-related sources suggest that the amount of captive coal is much higher than 53%. *Id.*

112. Twenty-one railroads received more than 10% of their revenues from hauling coal in 1981; ten exceeded $100,000,000 in coal revenues; and one exceeded $1,000,000,000. Ex Parte No. 347, *supra* note 20, at app. D. One utility, Arkansas Power & Light, recently estimated that the threat of competition saved consumers $16.5 billion over the life of a contract when compared to current ICC approval rates. *Id.*

simply seems to have ignored Congressional policy concerns about captive coal traffic while focusing solely on railroad revenue adequacy needs. The ability of the ICC to take its fairly one-sided position may not last long. Cases are pending which attack almost every position the ICC has adopted with respect to captive traffic pricing, and it appears that substantial judicial sentiment exists against some ICC views and policies.[113] This certainly should not be surprising, because Congress clearly intended to offer some regulatory protection for captive coal traffic beyond those afforded by competitive conditions, and the ICC just as clearly has not taken these Congressional concerns very seriously. As discussed earlier, since the Staggers Act no coal rate has ever been found too high by the ICC.[114] The policies adopted by the ICC with respect to captive coal are based on the supposition that competitive forces will keep transportation rates at reasonable levels, even in areas for which the ICC admits no transportation alternatives exist. Congress clearly rejected this viewpoint and the ICC's position is untenable in the short-run.

It is true that shippers of captive commodities will have to be harmed at least somewhat if railroads are to attain revenue adequacy. There is no other way to meet this desirable goal. This does not mean, however, that increases based on Ramsey Pricing, restrained only by a maximum cap in real terms of fifteen percent compounded annually, are an equitable solution to the problem of how a common carrier should be allowed to price differentially its services. Congress directed the ICC to afford some protection to captive commodities, and under current ICC policy those regulatory protections are nonexistent.

In *Arkansas Power & Light Company v. ICC*,[115] the court did not directly review ICC captive shipper policy because the case before it did not arise in the context of a specific factual issue, but it did offer some interesting observations about ICC policy which may well presage trouble for the ICC when its policies are reviewed on their merits in future cases. The court recognized the obvious Congressional interest, as expressed in the Long-Cannon Amendment, to offer some protections to captive shippers due to the fact that "carriers might use their monopoly traffic to subsidize other traffic that faced effective competition."[116] It noted that the Long-Cannon Amendment limited ICC discretion to ignore the issue by "requiring" that the Commission consider certain factors when reviewing rates on captive traffic.[117] Furthermore, the court voiced some concern about

113. *See* Arkansas Power & Light Co. v. ICC, 725 F.2d 716 (D.C. Cir. 1984).

114. *See* Consumers Power Co. v. Norfolk & W. Ry., No. 37854S, at 9-10 (I.C.C. served Jan. 18, 1984).

115. 725 F.2d 716 (D.C. Cir. 1984).

116. *Id.* at 719.

117. *Id.* at 720.

discovery and burden of proof problems currently placed on protesting shippers, found some aspects of ICC policy "disturbing" and others "that arguably stand in contradiction to the relevant statutory mandates."[118] The court chose not to review the issues at that time because the ICC's Coal Rate Guidelines had not yet been tested in a concrete case and were only a "*non-binding* statement of future intent."[119] But this case, as well as *Farmers Union Central Exchange v. Federal Energy Regulatory Commission*,[120] a proceeding which examined the Interstate Commerce Act's reasonableness standard, clearly evince judicial concern about unduly favorable rate of return standards for certain traffic and the total absence of cost-based pricing as an underlying basis for ratemaking. While there is no doubt that courts recognize the need for some restrained type of differential pricing, the ICC's current standards may not pass muster because of their unrealistic rationales and lack of concern about maximum reasonable rates for captive shippers.[121]

Bad law can still be good public policy, and, in the long-run, the ICC's position is defensible, and may even be desirable. In the long-run (that time frame beyond which utilities have the ability to choose where their power plants are located and producers the ability to open new mines freely), a shipper may be able to protect itself by contracting in advance with a railroad. Before a plant site is selected, an electric company may be able to play one railroad against another, or threaten to use barges or mine mouth generation, and, in general, promote free and open competition among all feasible transportation sources. As is the case now that ICC policy has changed, a long-term contract which guarantees the utility a set transportation rate (plus escalator provisions) for the expected useful life of the facility and guarantees the railroad a minimum annual volume of traffic for an extended period could be signed with a railroad before the plant site was selected. This relationship, again, is symbiotic in nature, with greater efficiency and lower capital costs accruing to the railroad because of the long-term certainty and continuous nature of the movement.

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118. *Id.* at 723-24.

119. *Id.* at 724 (emphasis in original).

120. 584 F.2d 408 (D.C. Cir. 1978). The court held that abusive or gouging rates are of themselves not just and reasonable, and largely undocumented evidence on competition cannot be the principal means of ratemaking. Departures from cost-based rates should be made only when non-cost factors are identified clearly and these factors justify the resulting rate levels.

121. Commissioner Sterrett, who is normally in agreement with most ICC actions, also recognizes the unfairness of some captive shipper decisions. He is concerned about the mechanical formula which has been substituted for ICC discretion in coal rate cases and that the guidelines are too heavily weighted against captive shippers. 48 Fed. Reg. 19,421 (1984). Support for this viewpoint could come from Chairman Taylor, and, with impetus from a few court decisions could cause somewhat of a shift in ICC policy. It is still far too early, however, to state that a shift in policy has occurred or is even being contemplated.

Possibly in the long-run, true competition will prevail and a position financially attractive to both sides will occur because shippers and carriers both have viable negotiating positions and alternatives. In recent cases, electric utilities publicly announced that they had saved the public hundreds of millions of dollars in transportation costs over the life of generating facilities, solely because their plants had access to two railroads from the source of coal rather than a single carrier as had previously been the case.[122] That sole carrier had been able to exercise monopoly pricing and capture a large portion of the consumer surplus associated with the utility's coal supply; but when the bargaining involved another carrier, the first railroad was forced to share *its* excess profit with the electric utility and the consumers in order to retain the freight. This is a classic example of the tug-of-war and interaction among utilities' and railroads' revenue and cost curves that was depicted in ICC coal decisions. In the long-run, this result may occur in some or all dealings between carriers and shippers. Competitive alternatives should be available for much traffic and economically efficient pricing will occur without the need for regulation, even for formerly captive traffic such as coal.

The point is that, in the long-run, coal is no longer captive. Competitive alternatives may exist for producers—to mine another site—and utilities—to choose another transportation alternative without sacrificing a large fixed investment. The problem with the ICC's position is that it has not significantly differentiated between the long-term and the short-term, despite the fact that, in the short-term, much coal remains captive. The ICC has simply adopted a short-run strategy for efficiently pricing coal transportation, but based it on considerations that are true only in the long-run or in those current situations in which a utility or producer happens to have access to alternative transportation.[123]

While it is true that long-run competition should end most coal industry concern about ICC policy, certain other trends are apparent that may cause problems because they substantially lessen available competition for freight. Mergers among major coal hauling roads have substantially reduced the number of possible carriers for coal.[124] Also, a major railroad presently has an application pending before the ICC to purchase

122. *C & NW, AP & L Sign Pact For 20-Year Coal Hauls; Pipeline Plan Threatened*, TRAFFIC WORLD, Aug. 1, 1983, at 19.

123. Typically, this consists of the utility building its own short-line railroad to connect its plant with another carrier, or pairing two or more plants together, some of which have transportation alternatives and some which do not. The utility then offers to give a railroad the traffic for which competition exists only if that carrier lowers its rates on the monopoly traffic. Arkansas Power & Light believes that the threat of building a coal slurry pipeline or a competitive alternative to an existing monopoly railroad saved it and its consumers approximately $16.5 billion. *Id.*

124. *See, e.g.*, Norfolk S. Corp.—Control—Norfolk & W. Ry. Co. and Southern Ry. Co., 366 I.C.C. 173 (1982).

America's largest barge company, which occupies an important competitive niche in that railroad's territory.[125] Finally, railroad refusals to sell right-of-way access and railroad lobbying have doomed current efforts to build several coal slurry pipelines, the most promising source of competition for captive coal. The anticompetitive implications of these moves could be staggering. The ICC's coal strategy presumes competition, but other ICC policy negates competition by reducing the number of viable carriers, putting various competing transportation modes under railroad control, and giving the railroads an effective veto power over competing technologies.

One final area of long-run concern, and one that the ICC has treated cavalierly or not at all, is the environment. In its export coal exemption decision, no environmental impact statement was found necessary by the ICC and in *Coal Rate Guidelines—Nationwide*, the ICC gave notice of intent to consider the effects of its actions on the environment and on energy consumption after it had reached its decision.[126] While the Commission's notice stressed that the guidelines were merely proposals, not binding policy pronouncements, it is apparent the environmental issues are not likely to play an important role in ICC policy. In fact, it appears likely that they have been ignored, except for a perfunctory, after the fact analysis. For instance, the ICC stated in its notice of intent that certain models estimating the environmental impact were likely to overstate the problems of the proposal.[127] Apparently the ICC was already making its case for ignoring negative data even before it saw the evidence. While the notice stressed the usual factors such as likelihood of modal shifts, commodity shifts, deferral of generating facilities, and shifts to foreign coal and comparisons of the environmental desirability of nuclear energy and coal, one of the most serious problems of the ICC policy was unmentioned—how it will affect future siting decisions of producers and electric utilities.[128]

When railroads were closely regulated, both producers and utilities could locate their facilities solely on the basis of site desirability, with the knowledge that they would not have to worry about railroad monopoly profits on their traffic. The ICC would make sure that they were treated equally with other shippers and receivers. Under the deregulated envi-

125. At the present time, the parent company of the American Commercial Barge Lines may be taken over by the CSX Corporation, a large railroad conglomerate with substantial coal-hauling facilities in the eastern and southern United States, the same territory in which American Commercial Barge Lines operates. *See* CSX Corp.—Control—American Commercial Lines, Inc., Finance Docket No. 30300 (I.C.C. decided Aug. 27, 1984).

126. 48 Fed. Reg. 9706 (1983).

127. *Id.*

128. *Id.*

ronment, this is no longer the case. Each mine and power plant must be sited so as to have access to two or more carriers, or modes, in order to maintain a competitive edge. A plant site on a navigable river or between two railroads may not be the most environmentally sound location, but it may be the most economically sound location. Furthermore, a plant may not be sited most efficiently for the needs of consumers in its service area due to the necessity of availing itself to two competing transportation modes. This could lead to additional energy consumption and wasted electricity because of excessively long transmission requirements and to additional environmental degradation resulting from extra coal being burned. When confronted with rising consumer protests from electric users and the possibility of billions of dollars in savings over the life of a project, many utilities may choose an environmentally or otherwise economically inferior site which has competitive transportation alternatives. At a minimum, utilities now have to factor transportation accessibility into their siting decisions, a constraint which previously was unnecessary. The same arguments also hold for producers, which also may find it necessary to switch mine locations in order to preserve transportation competition. Furthermore, the railroads, which own much coal property, may choose to price transportation such that their lands are developed to the exclusion, or at least detriment, of non-railroad owned coal.[129] This may have antitrust implications, but also environmental ones if the coal so favored causes more severe environmental problems due to its location and so on than non-railroad controlled coal.

It is unlikely that this argument will be publicly brought forth by the electric or coal industries, for two reasons. Given the small likelihood of change by the ICC, the utilities would not want to admit that any site they select is environmentally inferior, thus having to face the wrath of environmental groups and other regulatory agencies. Furthermore, electric utilities and coal companies often fight environmental regulations and litigation tooth and nail and may well find it hard to resort to these laws for help when they are so used to getting clubbed over the head by them in other proceedings.

Even if the arguments are unlikely to be raised by electric utilities, the issue should be reviewed. The ICC has a duty to consider foreseeable, but secondary impacts resulting from its actions that are likely to have environmental effects.[130] The Commission admits, however, that it knows

129. While 49 U.S.C. § 10746 (1982) prohibits railroads which own coal from also transporting it, railroads are now free to move their own coal for export, thus giving them a complete vertical monopoly position should they choose to exercise it. Furthermore, even for domestic consumption, they remain free to market their coal and affect competing coal production companies; they merely cannot transport the coal they own.

130. *South La. Envtl. Council v. Sand*, 629 F.2d 1005, 1016 (5th Cir. 1980).

very little about the effect on energy utilization and environmental impact arising from some of its coal decisions.[131] Additionally, the ICC has looked only at environmental concerns likely to arise from increased rates and has ignored other shifts such as the relationship between domestic and exported coal and other possibilities that might adversely affect the environment.[132] Chairman Taylor, in his dissent in the *Export Coal* decision, articulated most of the non-siting concerns very well.[133] Some heed should be paid to these issues before the ICC acts precipitously.

While the long-run implications of ICC coal policy may actually yield a balanced economic environment in which railroads, producers, and users compete equitably (although certain other problems may arise), the short-run picture is much less rosy for those who believe that the need for revenue adequacy should not be the sole determinant of railroad ratemaking. ICC policy is predicated on competition existing for traffic that has been determined to be captive or market dominant. Meaningful competition simply does not exist for this traffic in the short-run, and to base policy on that assumption is folly. The only recognition to date by the ICC of the needs of captive traffic is to defer unlimited railroad rate setting ability for a few years by limiting the *real* rate increases to fifteen percent compounded annually. This procedure gives captive shippers a few years before the full brunt of the policy is felt, but rates can still triple in eight years on this captive traffic, without even the possibility of ICC intervention and rate relief.

The ICC wants shippers and carriers to act as if competition exists and to engage in the aforementioned long-run marginal cost curve tug-of-war, but this policy is not satisfactory because many shippers have no short-run ability to withstand railroad attempts at extracting monopoly profits. This problem occurs for a variety of reasons. First of all, the railroads themselves control much coal land in the east and west. They could juggle transportation rates to favor their land, or they could lease their land to developers at favorable rates in order to determine what economic shifts in the market occur. Furthermore, their determination of whether to enter various markets and at what levels of output, would cause competitive harm to existing producers, thus making it less likely

131. *See* Railroad Exemption—Export Coal, supra note 102 at 608-10 (Taylor, A.L.J., dissenting).

132. *Id. See also id.* at 596-98; 49 U.S.C. §§ 10101a(15), 10701a(e)(2)(B)(iii) (1982) (expressing general and Long-Cannon concerns about the need for the ICC to consider environmental issues in its deliberations); Energy Policy and Conservation Act, 42 U.S.C. § 6362(b) (1982) (which requires the ICC to include a statement of probable impact on energy consumption and efficiency for all major regulatory actions); Implementation of the Energy Policy and Conservation Act of 1975, 357 I.C.C. 599 (1979) and 49 C.F.R. pt. 1106 (1984); Celanese Chemical Co. v. United States, 632 F.2d 568, 578-79 (5th Cir. 1980).

133. *See* Railroad Exemption—Export Coal, *supra* note 102, at 605-07, 608-10.

that these producers can stand up to the railroads in a bargaining situation. Even if the railroads do not act in such a manner concerning their lands, the realities of their power over transportation and over coal could give pause to any producer trying to buck them.

ICC arguments that shippers can protect themselves by signing contracts with carriers are equally fallacious.[134] While true in the long-run, the short-run picture is different. If shippers have no bargaining power, railroads will only sign contracts on terms most favorable to them, or will simply wait out the shippers by publishing tariffs as they see fit. As shippers have no possibility of stopping these rate increases, the railroads have no incentive to limit them by signing contracts, unless a competitive alternative exists for the shipper. Unequal bargaining power is not conducive to contract negotiation.

The ICC further suggests that railroads will have to be reasonable in their demands because many producers have separate mines operating on other rail lines, and may simply shift production from one to the other if one railroad's rates are not reasonable.[135] The problems with this viewpoint are many. First of all, coal from one mine may not match the sulfur, ash, etc., content of another mine, and may not be compatible, even when blended, with a particular power plant which the company must supply. Secondly, a multiple mine owner which closes some or all of its mines to force the railroads to lower rates loses a substantial part of its volume; the railroad, on the other hand, would lose an infinitesimally small share of its market by refusing to lower that mine's transportation rate and consequently losing its freight. Clearly, only in the most exceptional case would a mine owner, even with facilities on different carriers, be able to withstand the economic might of a railroad if the railroad refused to lower its rates. Furthermore, in many other circumstances, even the existence of apparent competition will not preclude the railroad from capturing all the excess profits. For instance, railroads now may refuse to offer a shipper reasonable rates on a short movement from the mine to a competing barge line, or a short movement to a competing railroad. Thus, the alternative movement posited by the ICC as promoting competition must take place solely via competing carriers because the ICC no longer is in position to require that interline rates or rates to barge facilities be non-discriminatory, fair, and reasonable. By the same token, for this carrier shift to work in most circumstances, the receiver, as well as the shipper, would also have to be served by two carriers. If only the original carrier serves the receiver, it could refuse to participate in a joint line movement, except at an exorbitant rate. In effect, only in those circumstances in which two

134. *Id.* at 588. *See also* Ex Parte No. 347, *supra* note 20, at 17.

135. *See* Railroad Exemption—Export Coal, *supra* note 102, at 593-94.

fully independent transportation alternatives exist can the railroad be prevented from capturing the entire consumer surplus associated with the coal.

The ICC also suggests that the railroads benefit from high volume coal shipments and will exercise voluntary restraint so as not to kill the goose that lays the golden egg, thus giving shippers some bargaining leverage.[136] When a monopoly exists, economic theory suggests that the monopolist does not maximize volume but rather maximizes revenues and profits. The principal economic problem with monopolies is that they cause higher prices and lower volume than would occur in a competitive situation. The railroads certainly would act as rational monopolists, and despite expressions of faith by the ICC, coal prices can only rise and volume fall so long as railroads possess market dominance over traffic.[137]

Much of the ICC's analysis of this problem has been based on railroads' need for revenue adequacy, which they cannot reach otherwise because competitive conditions force them to haul some freight at less than full cost, but more than variable cost. As the railroads typically have a downward sloping marginal cost curve, says the ICC, pricing their services at marginal cost leaves them with a permanent revenue shortfall, which cannot be made up so long as competition exists for some traffic unless other, captive traffic is charged higher rates. By coupling the railroads' monopoly power with pricing freedom, the ICC has put the coal industry in the same position of short-run subservience from which it has just rescued the railroads. The railroads, if they are smart enough and gather enough knowledge about market conditions, can capture all of the consumer surplus associated with coal and force shifts in the producers' marginal cost curves until they are just on the verge of shutting down. As coal producers also have downward sloping marginal cost curves, total producer revenues will now tend to fall short of total producer costs where marginal revenue equals marginal cost, thus leaving producers with a revenue shortfall equivalent to that formerly experienced by the railroads. The coal industry's revenue problems have not been solved, but only shifted from the railroad to the producer, and ultimately to the users of steel and electricity. Assuming perfect knowledge of market conditions by the railroads and producers, the above represents the rational short-run outcome in the absence of meaningful competition.

Assuming perfect knowledge by the railroads, producers and shippers is also a heroic assumption by the ICC. Railroads certainly do not have a history of quick reaction times to market shifts, and may well mis-

136. *Id.*

137. Whether volume will fall can be argued indefinitely. However, evidence does exist that such an occurrence could happen and that the issue does deserve serious consideration by the ICC in light of statutory requirements.

judge market conditions. Giving the railroads monopoly power and pricing freedom allows them to capture as much of the consumer surplus as their skills allow, but it also gives them the power to destroy a particular market through spite or simply miscalculation. If they incorrectly estimate the amount of consumer surplus or changes in market condition and price their services too dearly, a contract may well be lost and a mine closed. Railroads tend to be ponderous entities with a 100 year tradition of not competing, and it would be almost miraculous to expect their bureaucracies to be at the forefront of innovative and accurate marketing.

When the ICC shifted from fair, just, and reasonable pricing on captive traffic to what the market will bear, the effect was to increase costs to the principal consumers of coal—electricity consumers. In effect, all customers of coal burning utilities pay a tax to the railroads to make up for their revenue shortfalls from other commodities. This is a relatively painless way for the ICC to meet its revenue adequacy obligations to the railroads. Railroads and electric utilities are both regulated, and both typically pass through costs to their customers. The electric utilities are hurt somewhat by these transportation cost increases and do fight them vigorously, but consumers are the class ultimately hurt the most by captive market pricing. Coal, transportation, energy, consumer and environmental issues should be combined with concerns of equity for all affected groups when setting coal transportation policy, but the ICC has focused almost exclusively on one facet of the problem—railroad revenue adequacy—and almost totally ignored the others. The ICC's concern has been to prevent future railroad failures, and at least in the short-run, it has succeeded with a vengeance. Competing considerations mandated by Congress and suggested by non-railroad sources have been repeatedly overlooked. Unless the courts overturn some ICC policies, the short-run ability of the railroads to capture the consumer surplus, if any, which exists for a captive coal producer is limited only by the skill and imagination of the railroads. The long-run implications of the policy may be more competitively balanced, but given the long life of existing facilities built before ICC policy shifts, the captive shipper problems will be facing Congress and regulatory officials for many years.