

Railroads and the Marketplace

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I. INTRODUCTION**

Railroads have been regulated longer than most Americans have been alive. Grover Cleveland was serving his first term as president when the Interstate Commerce Commission (ICC) was created in 1887¹ to regulate rail rates and services—making railroads the first American industry to be brought under federal price controls. At the time, almost all domestic passenger and freight travel was by rail. Alternative transport was limited to horse and wagon over deeply rutted and often muddy roads, by steamboat on crudely improved rivers and canals, or by ocean packets under sail. Orville Wright was still a teenager.

Seventeen different presidents have occupied the White House since the passage of the original Interstate Commerce Act. The Panama Canal was constructed, permitting ocean liners rapid intercoastal transit. More than two million miles of roadway have been paved at taxpayer expense, including some 41,000 miles of high-speed Interstate Highway. Some 20,000 miles of inland waterways have been improved with public funds to facilitate commercial barge transport. Since World War II, pipelines have been utilized to transport most petroleum products. Jumbo cargo jets can fly coast-to-coast in five hours.

For decades, freight transportation in the U.S. has been competitive. But arcane, antiquated and rigid economic regulation prevented the railroads from competing—competing with each other and with trucks and barges.

Railroads were, until 1980, regulated as if they still held the vast market power that they did a century earlier. In 1957, *Business Week* magazine, "railroads have not had a practical monopoly of the transportation business for over thirty years."²

Nonetheless, federal and state regulations required railroads to petition for permission to raise or lower rates or adjust levels of service in response to changing economic conditions. Many rail-competitive truck and barge operators faced no such requirements, permitting them to react rapidly to changing markets and to ravage rail business with impunity. Rail pricing officers were, in the words of former Federal Railroad Administrator Robert W. Blanchette, "in the in-box of bureaucrats."

Railroads were also used as instruments of social policy. Railroads

** The *Transportation Law Journal* is not responsible for the accuracy of statistical data contained in this article.

1. An Act to Regulate Commerce Ch. 104, 24 Stat. 379.

2. *The Railroads: Too Much Plant, Too Little Business*, BUSINESS WEEK, July 13, 1957.

were required to make distant producers more competitive with local producers in a given market; to give preference to certain ports or regions of the nation; to help protect farm income; to help prevent unemployment; and to provide money-losing freight and passenger transportation as if railroads were philanthropic agencies.

By the mid-1970s, the rail industry was plagued by bankruptcies. The threat of nationalization hung over many railroads like the sword of Damocles. An estimated cost to taxpayers of nationalizing the freight railroads was \$100 billion³ and that would have been just the beginning. Economic efficiency always takes a back seat to political expediency.

Shippers and railroads alike rejected the nationalization alternative. Congress was equally chary—it knew that the pockets of the public treasury were not sufficiently deep. Indeed, the combined operating deficits of the nationalized rail systems in France, West Germany, Great Britain, Japan and Italy—systems whose combined route mileage is less than forty percent of U.S. railroads—exceeded the equivalent of \$2.6 billion annually in 1971.⁴

Having tried strict economic regulation—and seeing it fail—and having rejected complete nationalization—because of excessive cost and resulting inefficiency—policy makers were left with two options. The first was nationalization of only bankrupt and financially weak roads. But, observed the U.S. Department of Transportation (DOT), “it is difficult for the federal government to become a limited partner . . . such piecemeal nationalization would weaken—and perhaps eventually destroy—the vigor of the private enterprise companies that would be forced to compete with the federally backed operation.”⁵

A more efficient solution—a healthy dose of the free market—was chosen. “Reasonable rates,” said Congress, should be set by “competition and the demand for services . . . to the maximum extent possible.”⁶ Congress sought to loosen the reins of existing economic regulation, to give railroads an opportunity to earn adequate revenues—revenues that would attract the necessary new investments to renew facilities and prevent railroads from becoming wards of the public treasury.

To accomplish this, Congress in October 1980 passed the Staggers Rail Act⁷—named in honor of retiring Congressman Harley O. Staggers,

3. RY. AGE, Apr. 24, 1972.

4. *Northeastern Railroad Problem: A Report to Congress*, U.S. Department of Transportation, (Mar. 26, 1973). Route mileage by nation for 1971: U.S., 195,840 miles; Fr., 22,300; W. Ger., 18,900; Japan, 23,900; Gr. Brit., 22,800; and Italy, 9,950 [hereinafter cited as *Northeastern Railroad Problem*].

5. *Id.* at 3.

6. 49 U.S.C. § 10101a (1) (1980).

7. Staggers Rail Act of 1980, Pub. L. No. 96-448, 94 Stat. 1895.

chairman of the House Committee on Interstate and Foreign Commerce, where the legislation originated.

The Staggers Act did not completely deregulate the railroad industry. The measure limited the ratemaking jurisdiction of the ICC to instances where rail carriers are shown to have "market dominance" (the absence of effective competition) and where the rates at issue exceed variable costs⁸ by a prescribed percentage.

Evidence reveals the Staggers Act to be the most successful piece of transportation legislation ever passed by Congress. Despite a long and deep recession shortly after the Act was passed, and the on-set of a period of no-growth for freight traffic, no new rail bankruptcies occurred. Existing bankrupts were restructured successfully within the private sector.

The railroads have been able to survive in this difficult business environment because operating costs have decreased sharply, extraordinary cash-flow benefits have stemmed due to 1981 tax-law changes and purchases of equipment have declined.

Since Staggers was enacted, productivity and the quality of rail freight service have improved dramatically. Many rail rates have fallen, while rate increases are more moderate than before Staggers. Competition among railroads has increased, and the railroad industry is competing more successfully with trucking and shipping.

"A leaner industry has become more competitive under deregulation," said *Nation's Business* magazine.⁹ Observed *Fortune* magazine:¹⁰ "The Staggers Act did not leave shippers totally at the rails' mercy." *U.S. News and World Report* commented:¹¹ "In the world's largest free-market economy, entire industries are becoming accustomed to something they had long lived without: competition."

In a Cato Institute policy analysis, Kansas State University Professor Michael W. Babcock stated:¹²

[the Staggers Act] is a significant step toward economic efficiency in the rail

8. *Variable costs* are those that fluctuate directly with the rate of output—train labor, fuel, depreciation due to wear and tear of operations, most maintenance and repair. But to remain in business, railroads also must earn sufficient revenues to cover their fixed costs.

Fixed costs are those unaffected by the rate of output—track grading, ties, ballast, signals, buildings, minimum maintenance, management, interest on debt, property taxes, and depreciation related to obsolescence and weather. The additive of variable and fixed costs produce total costs.

9. *Why Railroads Are Making the Grade*, NATIONS BUSINESS, May, 1983.

10. *Railroads Flight to Fend Off Re-Regulation*, FORTUNE, Jan. 7, 1985.

11. *How Deregulation Puts Competition Back in Business*, U.S. NEWS AND WORLD REPORT, Nov. 26, 1984.

12. M. Babcock, *Efficiency and Adjustment: The Impact of Railroad Deregulation*, Policy Analysis No. 33, (Jan. 31, 1984), (The Cato Institute, Washington, D.C.).

industry. Railroads are now able to adjust their rates and service to changing market conditions and are no longer required to provide money-losing service. With a policy based on free-market principles, railroads will continue to play a major role in the U.S. economy.

II. A NATIONAL PROBLEM

The bankruptcy of the Penn Central Railroad in 1970—following decades of industry decline—seemingly set off a chain reaction, which, by 1975, saw virtually every railroad in the Northeast filing for protection from its creditors.

With the bankruptcies of the Chicago, Rock Island and Pacific Railroad (Rock Island) and Chicago, Milwaukee, St. Paul and Pacific Railroad (Milwaukee Road) in the mid-1970s, no section of the nation seemed immune from railroad failure.

By the Late-1970s, more than 21 percent of the nation's rail route mileage was being operated under the gavel of bankruptcy courts¹³—approaching the 33 percent of the mileage in receivership at the height of the Great Depression.

“The railroad industry problem . . . is a nationwide transportation problem,” Transportation Secretary Brock Adams told a U.S. Senate Committee in 1979.¹⁴ This is because more than half of all rail freight travels over two or more railroads,¹⁵ making the Nation's rail system only as strong as its weakest links.

The fact that some railroads were financially sound during the 1970s was of minor consequence to a shipper on such lines whose freight was designed to a region served by a bankrupt or deteriorating carrier. That an originating railroad might move freight efficiently mattered little if the destination carrier's track limited train speeds to ten miles per hour and its decaying terminals promise further delays.

A 1975 DOT study said that less than two-thirds of rail shippers found rail equipment availability and rail service to be adequate.¹⁶ The same study reported that almost 97 percent of truck shippers found motor-carrier equipment availability and service to be adequate.

The rail industry in 1976 faced a ten-year capital shortfall of as much

13. Economics and Finance Department, Association of American Railroads. [Hereinafter cited as E&F, AAR].

14. Statement of Brock Adams before Senate Committee on Commerce, Science and Transportation, Apr. 12, 1979.

15. Internal Analysis of Operations and Maintenance Department, AAR. [Hereinafter cited as O&M].

16. *A Prospectus for Change in the freight Railroad Industry*, U.S. Department of Transportation, Pgs. 19-31 (Oct., 1978). [Hereinafter cited as A Prospectus For Change].

as \$16.2 billion¹⁷—excluding Conrail. This was despite the fact that the ICC had permitted railroads to raise freight rates by thirty-two percent from 1967 through 1971—or more than ten percentage points greater than the 21.3 percent rate of consumer inflation.¹⁸

Railroads did not have the capital to properly maintain their track. The number of train accidents caused by track defects nearly quadrupled between 1966 and 1976.¹⁹ By 1976, 47,203 miles of track—25 percent of rail route miles—were restricted as to speed because of dangerous conditions.²⁰ Plagued by substandard profits—or no profits at all—many railroads deferred maintenance and delayed capital improvements in anticipation of better days that never arrived. By June 30, 1976, the value of accumulated deferred maintenance and delayed capital improvements exceeded \$2.8 billion for track, yards and terminals, and another \$1.3 billion for equipment—and this did not include Conrail.²¹

Though the ICC had permitted some 68,000 miles of rail line to be abandoned between 1920 and 1975²² (about 0.4 percent of total rail mileage annually), the rate of abandonment was not sufficient—in the face of more rapidly eroding business and changing transportation patterns—to prevent massive and costly excess rail capacity.

The excess capacity problem became so pervasive that in 1975, 33 percent of the nation's rail route miles carried only one percent of the freight; 66 percent of all rail freight was carried over just 20 percent of the route miles.²³ Between Chicago and Kansas City there remained eight mainline routes; five between Dallas-Ft. Worth and Houston; and five between Chicago and Minneapolis.²⁴ Chicago continued to be served by 22 railroads operating 105 separate terminal yards.²⁵

III. CAUSES OF RAILROAD DECLINE

The development of railroads in the United States during the 19th Century was in response to a demand for adequate and dependable overland transportation. Early government promotion of railroads permit-

17. *Id.* at 3-4.

18. *Railroad Revitalization and Regulatory Reform 3* (P. MacAvoy and J. Snow ed. 1977) (American Enterprise Institute for Public Policy Research Washington, D.C.).

19. *A Prospectus for Change*, *supra*, note 16, at 35.

20. *Id.* at 25.

21. *Id.* at 24 (Table 1-7).

22. *Study of Federal Aid to Rail Transportation*, U.S. Department of Transportation, V-28 (Jan., 1977).

23. R. Barber, *Railroads and Regulation: The Imperative Need for Change* 85, (May 1979) (Available at Richard J. Barber Associates; Washington, D.C.).

24. *A Prospectus for Change*, *supra* note 16, at 53.

25. *Id.*, at 53.

ted various national objectives to be fulfilled.²⁶ It also resulted in overbuilding, concentration of market power and a number of commercial abuses—common in other early American industries as well—that would not be tolerated today.

Passage of the Interstate Commerce Act and creation of the ICC in 1887 was in response to a fundamental change in public attitude toward railroads. The institution of maximum rate regulation alongside requirements that railroads fulfill politically defined social goals was tempered by the institution of rate floors. In theory, emerging regions, infant industries and selected shippers could be nourished through preferential rates and services while, at the same time, railroad revenue adequacy could be assured.

By the time the U.S. railway network reached its peak of 254,000 route miles in 1916,²⁷ the economic environment that spawned the Interstate Commerce Act had changed dramatically. Events were to carry the nation's oldest, largest and most successful industry to the brink of nationalization.

Beginning with the Transportation Act of 1920,²⁸ government attempted (and failed) to preserve a healthy national rail system while promoting the development of alternative domestic modes of transportation. In 1925, Congress passed the Hoch-Smith resolution²⁹ that directed the ICC, in regulating freight rates, to give preferential treatment to agricultural interests.

Tax dollars were used to build and maintain rights-of-way for rail competitors. Between 1946 and 1975 alone, federal spending on highways exceeded \$81 billion; on airports and airway supervision, \$24 billion; on inland waterways, \$10 billion; and on railroads, \$1.3 billion.³⁰

The Motor Carrier Act of 1935³¹ exempted from economic regulation most agricultural products moving by truck, and also exempted manufacturers and distributors who transported their own goods (private carriage). The Transportation Act of 1940,³² while extending economic regulation to barge lines, exempted their movement of bulk commodities such as coal, ore, grain and chemicals, which represented the vast portion of their business. Yet, strict economic regulation of rail operations continued—as if railroads remained a transportation monopoly. But rail markets were not protected—and certainly they were not secure. Secre-

26. Internal Memorandum, E&F, AAR, *supra* note 13.

27. F. Wilner, *Railroad Land Grants: Paid for in Full* (Washington, D.C., AAR, 1984).

28. Transportation Act of 1920, Ch. 91, 41 Stat. 456.

29. Pub. Res. No. 46; Ch. 120, 43 Stat. 801 (1925).

30. Study of Federal Aid, *supra*, note 22, at 10.

31. Motor Carrier Act of 1935, Pub. L. No. 255, 49 Stat. 543 (1935).

32. Transportation Act of 1940, Pub. L. No. 76-785, 54 Stat. 898 (1940).

tary of Transportation William T. Coleman, Jr. explained in 1975 that:³³

Only the railroads (with the exception of the pipeline companies) own their own rights-of-way and have to carry the fixed charges of ownership (including property taxes) and maintenance of this extensive plant.

In a misguided attempt to protect alternative forms of transportation, rates on much of the rails' competitive business were held by regulators to levels above those charged by barge and truck lines. A steady erosion of rail traffic and rail revenues ensued. Still, railroads were not relieved of their social-service obligations—such as uneconomic branch-line operations, and preferential treatment of certain regions, ports and shippers.

Declared Pennsylvania Railroad President James Symes in 1957,³⁴ "If railroads have to live for the next 10 years under the same conditions they have for the past 10, they will be in the hands of the government."³⁵ Stated the U.S. Department of Transportation in 1973,³⁶ "Regulatory practices have produced a rigid pricing structure which, for rails in particular, has prevented them from responding to the needs of a changing market."

Through much of the post World War II era, many railroads consumed themselves. The large scale of rail plant and the existence of long-lived assets masked the financial plight of many railroads until large segments of the industry collapsed beginning in the 1970s.

Not since the 1950s has railroad return on net investment equaled the industry's cost of capital; and in every year between 1963 and 1980, railroad capital expenditures exceeded retained earnings.³⁷ To operate oversized systems returning inadequate profits, railroads took on more and more debt. In the 1970s, interest rates on borrowed money rocketed to double-digits. Between 1970 and 1979, the rail industry's return on net investment never exceeded three percent—and dropped as low as 1.2 percent in 1975.³⁸ By then, Penn Central was losing \$2 million each day.³⁹ Billions of dollars in federal loans and loan guarantees to Penn Central's federally created successor, Conrail—as well as other financially strapped railroads—failed to address the fundamental national railroad problem of excessive economic regulation and bloated plant.

Poor earnings, poorer prospects, high-debt ratios and the reality of

33. *Crisis of the Nation's Railroads*, Report Prepared for President Gerald R. Ford, (Apr. 11, 1975), reprinted in P. MacAvoy and J. Snow, *supra*, note 18 at 10.

34. *The Railroads: Too Much Plant, Too Little Business*, BUSINESS WEEK, July 13, 1957.

35. Mr. Symes, whose Pennsylvania Railroad was part of the 1970 Penn Central bankruptcy, missed the mark for his railroad by three years. As mentioned earlier, many railroads remained relatively healthy during the 1960s and 1970s.

36. *Northeastern Railroad Problem*, *supra*, note 4 at 11.

37. Internal Memorandum, E&F, AAR, *supra* note 13.

38. *Id.* at 11.

39. Press Release of Penn. Central Transportation Company, (Feb. 4, 1975).

bankruptcies virtually squeezed nearly every railroad out of the equity markets. The effects were revealed in deferred maintenance, derailments, train accidents, increasing cargo damage payouts, equipment shortages and spotty service. This, in turn, forced even more shippers—and sorely needed revenues—from the rails.

In 1925, railroads hauled some 80 percent of inter city freight.⁴⁰ By 1975, the rail share of inter city freight had fallen to under 37 percent.⁴¹ In terms of inter city freight revenues, the railroads' share had fallen from 72 percent in 1929 to below 18 percent by the mid-1970s.⁴²

Viewed from another perspective, between 1947 and 1977, truck tonnage *increased* by 300 percent and barge tonnage *increased* by 250 percent—while rail tonnage *dropped* by 9 percent.⁴³

In the late 1960s, economist Merton J. Peck, a former member of the President's Council of Economic Advisers, characterized railroad regulation as a wasteful "misallocation of transportation resources." He wrote: [ICC rate policy has] denied the shipper the advantages of the lower cost transportation by rail, diverted resources toward the high-cost carrier, [and] added capacity to the non-railroad sectors of transportation at a time when the railroads had substantial excess capacity . . .⁴⁴

IV. BAND-AIDS ARE APPLIED

Throughout the 1950s and 1960s, the notion of a U.S. president visiting the Peoples Republic of China was unthinkable. The government that ruled mainland China did not exist as far as official Washington was concerned. Until the mid-1970s, a similar barrier existed with the notion of transportation deregulation. Among shippers, politicians and even railroads, deregulation was not a viable option.

Stated President Cleveland after passage of the Interstate Commerce Act in 1887: ". . . there appears no question that the policy thus entered upon has a permanent place in our legislation."⁴⁵

But, Congress noted in 1939: . . .

When the original act to regulate commerce was passed . . . railroads had a monopoly on transportation. In later years, competing forms of transportation have developed with such rapidity that no one now urges that there is any such monopoly . . . other forms of transportation are developed at public

40. *Transportation in America*, E&F, AAR. (1983) (Available at Transportation Policy Associates; Washington, D.C.).

41. *Id.* at 12.

42. *Id.*

43. *Id.*

44. M. Peck, *Competitive Policy for Transportation, The Crisis of the Regulatory Commission* 77, (1970).

45. *A Compilation of the Messages and Papers of the Presidents, 1789-1897*, (1898) (Available at U.S. Government Printing Office).

expense and without supervisory regulation.⁴⁶

Nevertheless, in passing the Transportation Act of 1940, which expanded motor-carrier regulatory exemptions and provided the bulk-commodity exemption to barge operators, there was no serious consideration of reducing the railroads' regulatory burden. Declared Congress: ". . . It may be safely said that neither the strictly regulated railroads nor the motor-carrier operators favor the elimination of all regulation."⁴⁷

High-valued merchandise traffic continued to shift from rail to truck, and savvy barge operators learned to win bulk commodities from railroads. Only the extraordinary transportation demands of World War II kept railroads reasonably solvent. Beginning in 1946, however, there began an unceasing financial erosion of the nation's railroads, leading to the demise of the Penn Central in 1970.

Rigidity born of excessive and inefficient economic regulation hindered the introduction of new services and prevented railroads from competing effectively for a share of the changing transportation marketplace. The railroad industry found itself unable to generate sufficient earnings to make needed improvements in track, roadbed and other facilities. Because of substandard earnings, funds from outside sources increasingly became unavailable.

The Transportation Act of 1958⁴⁸ authorized the Interstate Commerce Commission to "guarantee" \$500 million in loans to railroads for capital expenditures and maintenance. In its 1963 annual report, the ICC stated that without such loan guarantees—which expired in 1963—a number of eastern roads would not have survived.⁴⁹

Even with the failure of Penn Central, Congress continued to avoid the problem of too much regulation—choosing instead to treat the symptoms. A series of "Band-Aid" approaches, designed to stem the deadly hemorrhaging of cash, were instituted.

The Rail Passenger Service Act of 1970⁵⁰ relieved the nation's railroads from operating money-losing inter city passenger trains by creating the National Railroad Passenger Corporation (Amtrak).⁵¹ Passenger operations had cost the nation's privately owned railroads some \$1 billion for the four-year period from 1967 through 1970.⁵²

46. S. Rep. No. 433, 76 Cong., 1st. Sess. 3 (1939).

47. *Id.* at 13.

48. The Transportation Act of 1958, Pub. L. No. 85-625, 72 Stat. 568 (1958).

49. I.C.C. 77 Ann. Rep. 36 (1963).

50. The Transportation Act of 1958, *supra* note 48, at 14.

51. The Denver and Rio Grande Western (D&RGW) the Rock Island and the Southern Railway chose not to transfer their passenger divisions to Amtrak when it began operation on May 1, 1971. The Rock Island later was liquidated, while both the D&RGW and Southern subsequently transferred their passenger operations to Amtrak.

52. Internal Memorandum, E&F, AAR, *supra* note 13.

The Emergency Rail Services Act of 1970⁵³ authorized federal loan guarantees not to exceed \$200 million for bankrupt railroads without sufficient cash to continue "essential" operations.

The Regional Rail Reorganization (3-R) Act of 1973⁵⁴ set the stage for the creation of Conrail from the ashes of six bankrupt Northeast carriers⁵⁵ and authorized \$1 billion in federal loan guarantees for their future operation. Additionally, the 3-R Act authorized \$558.5 million in direct grants, including \$180 million to permit public authorities to purchase Conrail lines slated for abandonment; \$250 million to provide mandated lifetime salary protection for displaced rail employees;⁵⁶ \$85 million to provide operating subsidies for the bankrupts until they could be reorganized into a single system; and \$43.5 million to fund the U.S. Railway Association, which would act as Conrail's planning and financing agency. Also, the ICC was authorized to expedite line-abandonment applications of bankrupt carriers joining Conrail.

"A fast run toward total nationalization of America's railroads,"⁵⁷ observed syndicated newspaper columnist James J. Kilpatrick of these so-called Band-Aid remedies. "Congress seems intent on sending the whole system of capitalism careening to the fate of 'Old 97,'"⁵⁸ wrote *Railway Age* magazine editor Luther S. Miller.⁵⁹

Crisis legislation directed at immediate needs was not working. The financial problems of the railroads remained. Indeed, they began spreading from the Northeast westward. The Milwaukee Road and Rock Island were nearing bankruptcy and the rail industry's rate of return on net investment—1.2 percent for 1975⁶⁰—was well below the return available on a federally insured passbook savings account. Clearly, the pockets of the general treasury were not sufficiently deep to help rebuild the privately owned railroads' track and equipment and maintain it; and private capital was not forthcoming because of substandard earnings—or, more likely,

53. Emergency Rail Services Act of 1970, Pub. L. No. 91-663, 84 Stat. 1975.

54. Regional Rail Reorganization Act of 1973, Pub. L. No. 93-236, 87 Stat. 985.

55. The six bankrupt railroads merged into Conrail were Central of New Jersey, Erie Lackawanna, Lehigh and Hudson, Lehigh Valley, Penn Central and Reading. Bankrupt Boston and Maine Corporation chose to remain independent and subsequently was merged into Guilford Transportation Industries. The Ann Arbor Railroad subsequently was merged into Conrail. Conrail began operations April 1, 1976.

56. The Northeast Rail Services Act of 1981 (Public Law 97-35; 95 Stat. 643) repealed lifetime employee protection and placed a \$20,000 limit on individual benefits.

57. Miller, *The Northeast Bill: Pox; Panacea; or What*, RY AGE 5, (January 14, 1974).

58. A "fast" mail and express operated by the Southern Railway between Washington and Atlanta, that left the tracks at 90 miles per hour on Sept. 24, 1903 on a curve outside Danville, Virginia. Old 97 became the subject of a still-popular folk song.

59. *Id.* at 15.

60. Internal Memorandum, E&F, AAR, *supra* note 13.

no earnings at all. Total or piecemeal nationalization was not a workable public-policy option.

As early as 1954, Secretary of Commerce Sinclair Weeks headed a Cabinet Committee on Transportation Policy and Organization that recommended transportation deregulation to President Eisenhower.

On April 5, 1962 (the 75th anniversary of the ICC), in a special message to Congress on transportation, President Kennedy declared:⁶¹

The management of the various modes of transportation is subject to excessive, cumbersome, and time-consuming regulatory supervision that shackles and distorts managerial initiative.

Common carriers should be aided in their endeavors to maintain their status by being given relief from the burdens of regulation that handicap them against unregulated competitors . . . The role of public policy should be to provide a consistent and comprehensive framework of equal competitive opportunity. It means greater reliance on the forces of competition and less reliance on the restraints of regulation.

President Johnson, Nixon and Ford also recommended major changes in regulatory practices that would place more reliance upon competition and less upon regulation. It was not until the administration of President Carter, however, that Congress began to think the unthinkable—deregulation.

V. THE RAILROAD REVITALIZATION AND REFORM ACT

The Railroad Revitalization and Regulatory Reform (4-R) Act of 1976⁶² offered the first dose of deregulation since the railroads had come under price controls eighty-nine years earlier. The intent of the 4-R Act was two-pronged: To infuse much needed capital into the rail industry; and to provide railroads greater ratemaking, abandonment and merger freedom so that they could regain their financial independence.

In terms of capital infusion, the 4-R Act authorized 2.1 billion in loans to Conrail; \$1.6 billion in loans and loan guarantees to other financially weak railroads for plant and equipment purchases, and mainline track rehabilitation; and 360 million in branch-line subsidies.

The Interstate Commerce Commission was given authority to eliminate rate regulation over types of traffic where its deemed such regulation served "little or no useful public purpose." Rates that were equal to or exceeded variable cost were not to be held up in order to protect other carriers. No rate was to be found too high unless the ICC first found the rail carrier "market dominant" (to be explained shortly). For two years,

61. S. Conf. Rep. No. 14-595, 95th Cong., 2d Sess., *reprinted* in 1976 U.S. CODE CONG. & AD. NEWS 148.

62. Railroad Revitalization and Regulatory Act of 1976, Pub. L. No. 94-210, 90 Stat. 31.

railroads were to be given freedom to raise or lower specific rates by as much as 7 percent.

For the first time in the history of rail regulation, the Commission was to develop rate-reasonableness standards that took into consideration the revenue needs of railroads; and to make an annual determination of the rate of return required on net investment for the rail industry to attract and retain private capital.

In the case of mergers, the ICC was to reach a decision within thirty-one months. As for abandonments, time limits for Commission action were set and shipper financial contributions (through purchase or subsidy) were encouraged. The 4-R Act also prohibited discriminatory state and local tax treatment of railroad property.

The 4-R Act's intentions were good—at least the Act addressed the problem and not its symptoms. But it was a halfway measure, and its execution was severely flawed. Consequently, Conrail continued to lose money, and an additional \$1.2 billion in federal loans was authorized in 1978.⁶³ The Rock Island failed in March 1975 and the Milwaukee Road filed for bankruptcy in December 1977. Under the Milwaukee Railroad Restructuring Act of 1979⁶⁴ and the Rock Island Railroad Transition and Employee Assistance Act of 1980,⁶⁵ \$225 million in new loans and loan guarantees were authorized for maintaining essential rail operations and employee protection. The financial stability of the rail industry was far from being restored as envisioned when Congress passed the 4-R Act.

In 1978, the ICC determined that railroads required a rate of return of 10.6 percent⁶⁶ in order to attract the private investment capital that would allow them to properly maintain and renew plant and equipment. In that year, only three major railroads earned more than 7 percent, none more than 9 percent. For the industry as a whole, the rate of return for the twelve months ending September 30, 1978 fell to 0.24 percent⁶⁷—the lowest 12-month return in railroad history.

As Association of American Railroads' (AAR) official Richard E. Briggs explained:

From 1974 through 1978, the railroads produced three times as much freight service as they did from 1932 through 1936. Yet their recent average operating income before interest payments was only 20 percent as much, mea-

63. United States Railway Association Amendment Act of 1978, Pub. L. No. 95-565, 92 Stat. 2397 (1978).

64. Milwaukee Railroad Restructuring Act, Pub. L. No. 96-101, 93 Stat. 736 (1979). See also, Rowe, *Perceptions of Failure and Collective Bargaining in the Railroad Industry*, I.C.C. PRAC. J., March-April 1984, at 253-258.

65. Rock Island Railroad Transition and Employee Assistance Act, Pub. L. No. 96-254, 94 Stat. 399 (1980).

66. *Adequacy of Railroad Revenue* 362 I.C.C. 199.202 (1979).

67. Internal Memorandum, E&F, AAR, *supra* note 13.

sured in constant dollars (as it was during the Great Depression).⁶⁸

At a Senate oversight hearing on the 4-R Act in 1979, AAR President William H. Dempsey stated, "In the area of ratemaking reforms . . . the purposes of Congress have been thwarted—principally because of recalcitrance and poor implementation by the ICC."⁶⁹

Even though Congress intended the market dominance and other rate provisions of the 4-R Act, "to inaugurate a new era of competitive pricing,"⁷⁰ the ICC created three rebuttable presumptions in favor of finding that the railroad is market dominant and its rates, therefore, regulated.⁷¹ There were not countervailing presumptions for finding that market dominance did not exist.

The presumptions of market dominance were: 1) when a railroad handles 70 percent of involved traffic, 2) when the rate exceeds variable cost by 60 percent, or 3) when a shippers has made a substantial investment in rail-related equipment or facilities.

Initially, private carriage and potential geographic or product competition⁷² were not considered in applying the 70-percent market-share presumption, even though these are all recognized parts of economic life. In 1979, the ICC, citing a "misunderstanding," agreed to do so.⁷³ The 60-percent-over-variable-cost presumption was used as a rate ceiling to "impede railroad pricing even more than was the case prior to the 4-R Act," argued Mr. Dempsey.⁷⁴

The ICC interpretation of the 4-R Act was that if a railroad had discretionary power to raise rates, it had market dominance.⁷⁵ As much as

68. Before the Rural Transportation Advisory Task Force, April 4, 1979.

69. Before the Senate Surface Transportation Subcommittee of the Committee on Commerce, Science and Transportation, February 7, 1979.

70. Report of the Committee Conference on Railroad Revitalization and Regulatory Reform Act of 1976, 94th Cong., 1st Sess., 148 (1976).

71. Special Procedures for Making Findings of Market Dominance as required by the Railroad Revitalization and Regulatory Reform Act of 1976, 353 I.C.C. 875 (1976), 355 I.C.C. 12 (1976).

72. *Product competition* refers to the ability of a shipper or consignee to use a substitute for the involved commodity.

Geographic competition refers to whether the shipper or consignee can obtain the commodity from another origin or ship it to another destination—via other railroads. These are common and potent rate-negotiating tools for shippers.

73. Special Procedures for Making Findings of Market Dominance as required by the Railroad Revitalization and Regulatory Reform Act of 1976, 359 I.C.C. 735 (1979).

74. Senate Transportation Subcommittee, February 7, 1979.

75. As was the case before the 4-R Act, few railroads lowered rates. The reason was fear that when market conditions changed they would be prevented by regulators from raising them even to the pre-reduction level; and that other regulations, requiring rates to be equal over competing routes, would force them to lower rates other than the ones intended, even when market conditions differed among the routes. Railroad rates prior to the Staggers Rail Act bore little relationship to economic reality. They were mostly the product of "historical accident." C.

three-quarters of all rail traffic was thus considered "market dominant" by the ICC⁷⁶—despite the existence of an ICC-ordered consultant's study (ignored by the Commission) that concluded only 10 to 15 percent of all rail traffic was market dominant.⁷⁷ According to a 1975 report by the Bureau of the Census, truck transportation was dominant in twenty-three of twenty-eight states surveyed.⁷⁸

Observed transportation consultant Richard J. Barber in 1979:

There is something utterly unreal about a situation in which the rail share of total intercity tonnage carried has fallen to 26.6 percent . . . and the rail rate of return has fallen almost of zero, yet the ICC decrees that for one-half to three-fourths of their traffic the railroads are 'market dominant.'⁷⁹

Even though the rail industry was demonstrably revenue inadequate, and even despite Congress' concern for rail revenue adequacy as evidenced by language in the 4-R Act, the ICC adamantly refused to consider revenue adequacy as anything more than "one important factor" among many.⁸⁰

Unlike heavily regulated—and market protected—electric utilities, railroad markets were subject to intense competition from less regulated motor-carrier and barge operators—competitors whose rates of return on investment were 15 percent and 7 percent, respectively, while railroads were posting returns of less than 3 percent throughout the 1970s.⁸¹

VI. THE BRIGHT SIDE

Enacted in an atmosphere of hopeful expectations, the 4-R Act did little to lift from the railroads the gloom of despair.

A study by the Federal Railroad Administration—mandated under the 4-R Act—concluded that the railroads' financial situation would only worsen in time.⁸² Indeed, three years after passage of the 4-R Act, much of the railroad industry remained mired in substandard earnings.

Conrail was still swimming in a rising sea of red ink. The Rock Island

Barnekov, *Regulation Magazine*. Barnekov explains that because of the lengthy and costly regulatory burden railroads had to overcome in order to adjust rates, rail pricing typically resorted to across-the-board general rate increases as costs rose. As a result, the rail rate structure tended to reflect cost patterns that existed decades earlier, ignoring changes in technology and traffic flow that had significantly altered those cost patterns.

76. *The Impact of the 4-R Act Railroad Rate-making Provisions*, I.C.C., (October 5, 1977) at 42.

77. A. T. Kearney Management Consultants, Inc., *A Study to Perform an In-Depth Analysis of Market Dominance and its Relationship to Other Provisions of the 4-R Act*, (1979).

78. *Census of Transportation*, U.S. Bureau of the Census.

79. Barber, *supra*, note 23, at 20.

80. *Standards and Procedures for the Establishment of Adequate Railroad Revenue Levels*, I.C.C., ex parte no. 338 at 13.

81. Internal Memorandum, E&F, AAR, *supra* note 13.

82. *Id.* at 22.

virtually ceased to operate during the summer of 1979, with the Kansas City Terminal Railroad providing federally funded "directed service" over Rock Island lines using Rock Island employees.⁸³ By the fall of 1979, the Milwaukee Road had exhausted its cash.⁸⁴

Despite record traffic levels for 1979 (914 billion ton-miles, with strong increases in grain and coal loadings), the railroad industry's rate of return on investment increased to only 2.93 percent.⁸⁵ By contrast, federally insured certificates of deposit were yielding in excess of 11 percent during 1979.

However, the 4-R Act did prove that regulatory reform could be achieved in Congress—The 4-R Act being the precursor of extensive deregulation in the transportation industries. Domestic airline transportation was deregulated in 1978.⁸⁶ In mid-1980, the Motor Carrier Act was passed, which virtually removed entry, exit and most rate controls for truckers.⁸⁷ The Staggers Rail Act became law in the fall of 1980. The Northeast Rail Services Act of 1981 exempted Conrail from the more restrictive line-abandonment provisions of the Interstate Commerce Act. And, the Bus Regulatory Reform Act of 1982 deregulated interstate bus transportation.⁸⁸

The 4-R Act had begun this process by recognizing that railroads—like all other businesses—require the opportunity to earn a rate of return on investment equivalent to the current cost of capital.⁸⁹

The 4-R Act also established that railroads should not be prevented—by bureaucratic delays—from adjusting rates in competitive markets so that they can compete effectively.

Finally, the 4-R Act recognized that some rail movements need not be subject to regulation at all. In 1979, the Commission used authority it had received under the 4-R Act to exempt from regulation the rail movement of fresh fruits and vegetables.⁹⁰ The movement of fresh produce by truck had never been subject to economic regulation; and by 1977, the rail share of this traffic moving in truck-competitive piggyback service had virtually disappeared, falling to 0.2 percent.

Freed to compete, the railroads began to gain a market share of this

83. 49 U.S.C. 11125 (1978).

84. Rowe, *supra*, note 64 at 22.

85. Internal Memorandum, E&F, AAR, *supra* note 13.

86. Airline Deregulation Act of 1978, Pub. L. No. 95-504, 92 Stat. 793 (1980).

87. Motor Carrier Act of 1980, Pub. L. No. 96-296, 94 Stat. 793 (1980).

88. Bus Regulatory Reform Act of 1982, Pub. L. No. 27-261, 96 Stat. 1102 (1982).

89. Economists describe the cost of capital as the opportunity cost of funds. The opportunity cost of funds is the income that is foregone because the funds cannot be used elsewhere. If any business is to survive in the long run, its revenues must cover its current cost of capital. If the investor cannot earn the current cost of capital, he will transfer the capital to some other use.

90. Ex parte 346, Sub. 1; 361 I.C.C. 211.

commodity. By 1980, the rail share had climbed to 1.4 percent; in 1984 to 5.9 percent; and in 1986 was 6.2 percent.⁹¹ Railroads use their new economic freedoms to establish market-sensitive rates and services.

VII. THE STAGGERS RAIL ACT

The Staggers Rail Act of 1980 permitted the dynamics of market forces to operate in the railroad industry.

In passing Staggers, Congress made a series of findings⁹² confirming what railroad officials had been maintaining for more than a decade: 1) most transportation in the U.S. is competitive, 2) nearly two-thirds of the nation's intercity freight is transported by modes other than rail, and 3) failure to achieve increased earnings within the rail industry will result in either further deterioration of the rail system or the necessity for additional federal subsidy.

Some of the goals⁹³ of Staggers were to assist the industry in its rehabilitation under private ownership; to reform federal regulatory policy to preserve an efficient, economical and financially stable system; and to provide the regulation necessary to balance the needs of carriers, shippers and the public.

As the Edison Electric Institute astutely observed:

. . . regulators must balance their efforts to keep down immediate consumer costs against the even more important responsibility to assure adequate (service) . . . Restrictive and erratic regulation has increased investor risk while holding returns below those offered by such investments as money-market funds, savings certificates and some government securities.⁹⁴

Under the Staggers Act, railroads were to enjoy the market freedoms necessary to seek adequate revenues in the competitive marketplace—freedoms long available to rail-competitive truck and barge operators, as well as to virtually all other industries.

The intent of Staggers—as with the 4-R Act before it—was not a promise of prosperity for the railroads. Staggers did not promise long-term survival of any particular railroad, nor did it guarantee that the railroads would reach revenue adequacy. Staggers gave the railroads only an opportunity for survival—within the framework of the competitive marketplace.

Signed into law by President Carter on October 14, 1980, Staggers built upon the framework of the 4-R Act by making nine fundamental regulatory changes:

91. Office of Transportation, U.S. Department of Agriculture.

92. House Report 96-1430, 96th Cong., 2d Sess. (1980) at 3.

93. *Id.* at 24.

94. Statement of Claire V. Hansen of Edison Electric Institute as published in *The Washington Post*, Feb. 14, 1882.

- 1) Demand and competition were to be the principal regulators; regulation of maximum rates was to continue only where an absence of effective competition exists.⁹⁵
- 2) Where the Interstate Commerce Commission retains jurisdiction of rail rates, it must take into consideration the revenue adequacy of a railroad in determining whether or not a rate is "reasonable."⁹⁶ (Although the Commission has emphasized that absence of revenue adequacy will not, in itself, guarantee approval of a rate.)
- 3) A rail cost recovery index—to measure the impact of inflation on railroad—was mandated. It permits quarterly rate changes to offset the increased costs of labor, materials and supplies, and is called the Rail Cost Adjustment Factor (RCAF).⁹⁷
- 4) The ICC was to relinquish jurisdiction over minimum rates that contribute to going-concern value.⁹⁸
- 5) Competing routes and services could be priced differently, to reflect the demand for each.⁹⁹
- 6) Like every other business, railroads were permitted to enter into confidential contracts¹⁰⁰ with their customers—contracts which, among other factors, could cover a guaranteed volume of freight for a specified time and with a guaranteed level of service.¹⁰¹
- 7) Collective ratemaking was effectively abolished. Railroads can no longer collectively discuss single-line rates, and discussion on joint-line rates was limited to railroads that directly connect.¹⁰²
- 8) The power of the Commission to authorize exemptions from regulation was expanded to all cases where regulation was not necessary to carry out the National Transportation Policy and the matter exempted was of limited scope, or regulation was not needed to protect shippers from an abuse of market power.¹⁰³
- 9) States were required to conform their standards for intrastate rail regulation to those used by the ICC.¹⁰⁴

Congress was aware that the ICC had previously thwarted (under the 4-R Act) directives to permit railroads greater freedom to raise and lower

95. 49 U.S.C. 10709 (1978).

96. 49 U.S.C. 10701a (b) (3) and 10704 (a) (2) (1978).

97. 49 U.S.C. 10712 (1978).

98. 49 U.S.C. 10701a (c) (1) and (2) (1978).

99. 49 U.S.C. 10741 (e), (f) (3) and (f) (4) (1978).

100. Ex parte 358-F; 361 I.C.C. 205. In 1978, the ICC—for the first time—announced it would look favorably upon rail shipper contracts—so long as they were open for public inspection. Previously, rail contracts were prohibited for fear they would weaken the common-carrier concept. Only a handful of contracts were signed—most shippers fearing that to do so would mean disclosure to their competitors of market volumes, supply sources, and transportation costs; some railroads were wary that the ICC's decision might be overturned by the courts. It was not until confidential contracts were permitted that shippers and carriers embraced them, as will be explained.

101. 49 U.S.C. 10713 (1978).

102. 49 U.S.C. 10706 (a) (3) (A) (1978).

103. 49 U.S.C. 10505 (1978).

104. 49 U.S.C. 11501 (1978).

rates. Recall that the Commission had found that in almost every case in which the railroads had discretionary power to raise rates, the railroads possessed market dominance.

Unwilling to trust subjective measures of market dominance, Congress required that a carrier cannot be found market dominant if the rate is below a specific revenue-to-variable-cost percentage. (The ratio began at 160 percent in 1980 and rose, by 1985, to 180 percent—where it remains.)¹⁰⁵ Similarly, tough standards for suspending rates pending investigation of their lawfulness were enacted.

Additionally, both abandonment and merger proceedings were expedited and shippers wishing to keep noneconomic lines open were granted new powers to acquire or subsidize those lines. Otherwise, the standards of the 4-R Act relating to abandonment and merger essentially remained unchanged.

Finally, the Railroad Accounting Principles Board was authorized to “establish principles governing the determination of economically accurate railroad costs.”¹⁰⁶ Due to a delay in Congressional funding, the Board did not begin its work until 1985 and was in the process of providing a final report as of this writing.

VIII. THE RECORD SINCE STAGGERS

Railroad earnings have not improved since passage of the Staggers Act. Railroads survived the recession of 1981-1982—and continue to survive today—because of reductions in operating costs, because of extraordinary cash-flow benefits stemming from a 1981 tax-law change, and because of reduced equipment purchases.

In fact, earnings—when adjusted for inflation—actually have declined since Staggers and have taken a precipitous drop during the past two

105. The ICC subsequently established additional guidelines for determining whether or not railroads are market dominant. The existence of rail-to-rail competition and rail-truck or rail-barge competition are to be considered, as well as product and geographic competition. The U.S. Fifth Circuit Court of Appeals, *en banc*, subsequently upheld the legality of these guidelines. The result has not been a virtual “blank check” to railroads to raise rates and “gouge” shippers, as will be shown.

Of 82 market dominance cases so far decided at the ICC (by administrative law judges, review boards or the full Commission), 65 have been in favor of the shipper. And, of 57 rate reasonable cases—following a finding of market dominance—so far decided at the ICC (by administrative law judges, review boards or the full Commission), 21 decisions have been in favor of the shipper. In two decisions, Burlington Northern Railroad was ordered by the full Commission to refund to two coal shippers a total of \$57.9 million, plus interest. *Western Coal Traffic League v. U.S.*, 719 F.2d 772 (1983), *cert. denied*, *Western Coal Traffic League v. U.S.*, 104 S.Ct. 2160 (1984); *San Antonio Public Service v. Burlington Northern et. al.*, Case No. 36180; and *Omaha Public Power District v. Burlington Northern*, Case No. 38783.

106. 49 U.S.C. 11161 and 11162.

years.¹⁰⁷ Inflation-adjusted net railroad operating income (NROI) for 1986 is 31 percent below its 1980 level—and in no year since 1980 has NROI exceed its 1980 level.¹⁰⁸ NROI reflects net after-tax income attributed solely to rail operations, exclusive of interest, other fixed charges and special charges related to employment reductions and one-time equipment write-downs.

NROI SINCE 1980
(Adjusted for Inflation)

	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>
NROI (billions)	\$1.3	\$1.2	\$0.6	\$1.1	\$1.3	\$1.0	\$0.9
Index (1980=100)	100	92	46	85	100	77	69

Other measures of financial performance paint a similar picture. For example, when measured by the basic test of long-run economic viability—a return on net investment equivalent to the current cost of capital—the rail industry's problems remain pressing.

For the years 1981 through 1986, the industry's rate of return on net investment (ROI) sharply trailed the industry's current cost of capital.¹⁰⁹ After reaching a high of 4.7 percent in 1984, ROI again began falling. On a comparable accounting basis, profitability has fallen below the 4.2 percent posted in 1980 and is only slightly better than the 2.9 percent recorded in 1979.

RETURN ON INVESTMENT VS. COST OF CAPITAL

	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>
ROI	4.2%	4.0%	2.1%	3.6%	4.7%	3.6%	3.5%
Cost of capital	12.1	16.5	17.7	15.3	15.8	13.6	N/A

(ROI based upon Retirement-Replacement-Betterment (R-R-B) method the only comparable method available for the entire period. 1986 ROI estimated. Special charges related to employment reductions and one-time equipment write-downs not included. See f.n. 109 for ROI on a depreciation accounting basis, in effect for railroads only since 1983. Those numbers also show declines in profitability during the past two years.)

107. Internal Memorandum, E&F, AAR, *supra* note 13. Using Retirement-Replacement-Betterment (R-R-B) method of accounting, the only comparable method available for the years 1980-1986. Calculations exclude special charges related to employment reductions and one-time equipment write-downs.

108. *Id.* at 28.

109. Return on investment (ROI) figures from E&F, AAR; cost of capital figures from I.C.C. proceedings ex partes 415, 436, 458 and 464, respectively. On a depreciation accounting basis (under which the railroads were placed in 1983), returns for 1983, 1984, 1985 and 1986 were 4.3 percent, 5.7 percent, 4.8 and 4.1 percent, respectively. Special charges for employment reductions and equipment write-downs also excluded.

The railroads' return on shareholders' equity, meanwhile, has been eroding and is woefully deficient when compared with that of the electric utility industry or all of American industry:¹¹⁰

RETURN ON EQUITY

	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>
Elec. Utilities	10.7%	12.4%	13.2%	14.3%	14.9%	14.4%	N/A
Railroads	6.0	10.5	5.4	7.3	9.8	6.8	2.1
All Industry	14.4	13.7	10.9	10.6	13.5	11.5	11.6

(The industry's change to depreciation accounting in 1983 makes the years 1983-1986 not comparable with prior years.)

The stock market similarly reflects the fact that rail earnings continue to lag those of most American industry. Since 1980, the Standard and Poor's (S&P) Rail Index has dramatically underperformed other stock indicators, with the S&P Electric Utility Index increasing almost four times faster than the rail index, and both the Dow Jones (DJ) Industrial and Transportation Indices advancing about three times as fast.

PERCENT CHANGES IN STOCK INDICES

(Year-end 1980 - Year-end 1986)

<u>S&P</u>	<u>DJ</u>	<u>DJ</u>	<u>DJ</u>	<u>S&P</u>	<u>S&P</u>	<u>S&P</u>
<u>Elec. Util.</u>	<u>Trans.</u>	<u>Indus.</u>	<u>Util.</u>	<u>500</u>	<u>Trans.</u>	<u>Rail</u>
+114%	+103%	+97%	+80%	+78%	+56%	+27%

In short, rail earnings have not improved since Staggers and remain well short of what the industry needs for long-term viability and what other industries are achieving.

However, the marketing freedoms bestowed by Staggers permitted the railroads to weather the deep recession of 1981 and 1982—the longest and deepest since the Great Depression—without a bankruptcy. Prior to Staggers, a recession of such a magnitude would have left a number of railroads bankrupt—a fact to which history attests. Staggers also provided railroads with some of the tools needed to adjust to dwindling industrial demand and immense increase in intramodal and intermodal competition.

Though rail earnings remain perilously substandard—tarring with falsehood allegations that railroads have become wealthy since Staggers' passage—deregulation has resulted in many successes.

Conrail, once a seemingly hopeless ward of the state, posted an 8.7 percent return on investment in 1984, a 6.1 percent return in 1985 and a

110. Internal Memorandum, E&F, AAR, *supra* note 13; for electric utilities; Moody's Utility Index; for all industry, Value Line Industrial Composite.

5.2 percent in 1986.¹¹¹

Said Conrail Chairman L. Stanley Crane after Congress voted to return the rehabilitated carrier to the private-sector, "I am convinced that we would have no Conrail to sell today without the Staggers Rail Act of 1980 . . . the nation's rail system remains a private-sector industry only because of (Staggers)."¹¹²

Meanwhile, the previously bankrupt Milwaukee Road was pared to profitable size and, following a spirited bidding war, merged with the Soo Line Railroad. Though the Rock Island was liquidated, much of its former trackage was gobbled up in active bidding. In New England, Guilford Transportation Industries was formed out of three carriers once thought on the road to extinction—Boston and Maine, Delaware and Hudson, and Maine Central.

Staggers permitted and encouraged a more business-like approach to railroading. Since 1980, the nation's major railroads have shed more than 20,000 route miles, slimming down to a national system of just over 140,000 miles.¹¹³ Now, the railroads are doing more intensive maintenance work on downsized systems. Since 1980, Class I railroad employment has been reduced by almost 200,000, or 40 percent.¹¹⁴

Some 140 short line or regional railroads have been created since 1980—versus only seventy-five during the thirty-year period preceding 1980.¹¹⁵ These are smaller businesses whose unique lower cost structure permits them to turn a profit where major railroads cannot.¹¹⁶ Short lines preserve rail service and rail jobs that otherwise would be lost, and prevent diversion of business to the highway. Their creation has significantly reduced potential railroad line-abandonment applications.

As the railroads were learning to do business in a less-regulated, more competitive environment, they also enjoyed extraordinary cash-flow benefits from two sources—the Economic Recovery Tax Act of 1981,¹¹⁷ and a reduced requirement for new rolling stock and locomotives.

That tax measure, in part, changed the railroads' method of accounting for tax purposes, permitting rapid depreciation of an investment base in track that never had been allowed to reflect depreciation. The so-called "frozen" asset base created by the previous retirement-replacement-bet-

111. Internal Memorandum, Consolidated Rail Corp.

112. Letter of L. Stanley Crane to Congress (Jan. 7, 1987).

113. Internal Memorandum, E&F, AAR, *supra* note 13.

114. Internal Memorandum, U.S. Railroad Retirement Board.

115. Internal Memorandum, American Short Line Railroad Association.

116. P. Rousselot & G. Mayo, *The New Short Line Revolution*, TRAFFIC WORLD, March 3, 1986 at 80. See also, H.A. Levine, C.F. Rockey, C.C. Eby & J.L. Dale, *Small Railroads*, (1982); F.N. Wilner, *Labor Protection Moves Seen Stunting Growth of Short Lines*, TRAFFIC WORLD, Dec. 29, 1986 at 59; and *A Carload of Deals in Regional Rails*, BUSINESS WORLD, Jan. 19, 1987 at 90.

117. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172 (1981).

terment system of accounting was allowed to be written off rapidly, using an accelerated, five-year method that provided a one-time cash flow of \$2.5 billion.

Cash-flow also was improved as a result of reduced orders for new freight cars and locomotives stemming from an oversupply of privately owned freight cars, depressed business levels and improved fleet utilization. Average annual freight car installations fell from 69,000 for the five-year period ending with 1981 to 12,000 for a similar period ending with 1986.¹¹⁸ Average annual new locomotive installations also fell over that time period—from more than 1,100 annually to just 375.¹¹⁹

Increased cash flow helped maintain unprecedented capital investment in track, yards, terminals and research. As a result, the tracks of many railroads literally were lifted out of the mud in the past decade.

In the mid-1970s, a new term was coined, "standing derailment," to describe the phenomenon of freight cars falling off collapsing track while standing still. Today, deferred mainline maintenance virtually has been eliminated, and many freight trains travel at seventy miles per hour. Railroad contracts guarantee train arrival times—many of which are competitive with the fastest motor-carrier service.

Improved track has resulted in safer operations. Since 1980, the number of train accidents has been trimmed by 60 percent, with those caused by track defects down by 63 percent.¹²⁰ Observes Federal Railroad Administrator John H. Riley: "[y]ou've used that cash flow to reshape your infrastructure into a safer system, as well as a more efficient one."¹²¹

Industry expenditures for research and development are at record levels. In slightly more than a decade, the research budget managed by the AAR jumped from under \$5 million annually to almost \$40 million¹²²—and that does not include what individual railroads and rail supply firms spend on proprietary research.

AAR research programs are seeking improved freight car design; more wear-resistant steels for track, equipment and components; applications for alternative fuels; and broader specification for residual fuels for locomotives, robot applications; a totally redesigned freight train that can reduce operating costs by as much as 50 percent; and advanced central-

118. Internal Analysis Endorsing Staggers Rail Act, Operations and Management Department, American Association of Railroads, (May 2, 1985).

119. *Id.* at 32.

120. Federal Railroad Administration, Office of Safety, U.S. Department of Transportation, Accident Incident Bulletin No. 154 (July, 1986).

121. Frank N. Wilner, Before Harriman Safety Awards Luncheon, Washington, D.C. (April 23, 1985).

122. Research & Test Department, Internal Analysis, American Association of Railroads.

ized train control based upon computer, microwave and fiber-optic technology.¹²³

Freight loss and damage claims payouts by railroads have been reduced dramatically. The claims payout for each \$100 in freight revenue, which was \$1.83 in 1975, has been reduced to \$0.46 in 1985—a 75 percent reduction.¹²⁴

All things being equal, Staggers' passage might have resulted in railroads a rate of return equivalent to their cost of capital. All things rarely are equal.

In 1980, Congress virtually eliminated entry requirements for motor carriers, scrapped most operating restrictions and gave truckers almost total pricing freedom¹²⁵—one result being creation of thousands of new, low-cost trucking companies. Congress in 1982 liberalized laws as to the maximum length, size and weight of trucks permitted on federal-aid and Interstate Highways—without sufficient increases in user charges to cover the full pavement damage caused by heavier axle loadings.¹²⁶

Rail-competitive motor carriers—often non-union firms—best able to take advantage of this environment have slashed their per-mile operating costs by as much as 28 percent since 1982.¹²⁷

Truckers, meanwhile, are lobbying for even greater size-weight liberalizations, permitting them to operate twin 48-foot trailers—as heavy as 134,000 pounds—nationwide. The result could reduce current rail pre-tax net revenues by as much as 65 percent as some tonnage is diverted and railroads reduce rates to mitigate that diversion.¹²⁸

Also, since passage of the Staggers Act, a fundamental shift in our economy has occurred. We face greater foreign competition for manufactured goods both home and abroad. Energy shortages have resulted in the downsizing of many products. We are moving from a manufacturing-based—or smokestack—economy to one of greater service orientation. Since 1980, the percentage of gross national product attributable to “goods” has fallen by more than three percentage points, while that attributable to “services” has climbed by almost four percentage points.¹²⁹

Railroads traditionally have had a symbiosis with smokestack

123. Frank N. Wilner, *High Technology Helps Railroads Reduce Cost*, DEF. TRANS. J., Oct, 1986 at 24-27.

124. Freight Claim & Damage Prevention Division, O&M, AAR.

125. Motor Carrier Act of 1980, Pub. L. No. 96-296, 94 Stat. 793 (1980).

126. Surface Transportation Assistance Act of 1982, Pub. L. No. 97-424, 96 Stat. 2097 (1983).

127. Intermodal Policy Division, Internal Analysis, American Association of Railroads.

128. *Id.* at 34.

129. Survey of Current Business, (1986); and Economic Report of the President, U.S. Department of Commerce (1986). Between 1950 & 1980, the percentage of Gross National Product attributable to “goods” and “services” has risen by 10 percentage points.

America. But since 1980, nine of the industry's "top ten" commodities are down in terms of carloadings. For example, carloadings provided by iron ore are off by 50 percent; by iron and steel off by 50 percent; by phosphates and industrial sand off by 41 percent; by pulp and paper off by 38 percent; by lumber off by 15 percent; and by choking coal off by 14 percent.¹³⁰ Overall, rail freight carloadings are down by almost 14 percent since 1980.

Railroads have responded with unprecedented cost-cutting in an attempt to replace those lost "traditional" tonnages with consumer-oriented traffic moving by truck. Various indices of productivity have increased as high as 43 percent since 1980.¹³¹ New agreements with rail labor have liberalized decades-old work rules that artificially inflated the cost of doing business.¹³² In 1986 alone, nationwide rail operating expenses were slashed by some 6 percent.¹³³

Since 1980, piggyback and container loadings have increased by 63 percent, reflecting the railroads' determination to go head-to-head with rail-competitive trucks. Margins on that traffic, however, are extremely thin, limiting its contributions to the railroads' relatively large overhead costs.¹³⁴

The one-time cash-flow benefits of the 1981 tax act have ended. With the disappearance of equipment surpluses, railroads will need to increase their freight-car and locomotive purchases to replace fleets that are subject to greater use. Omnibus tax reform legislation¹³⁵ passed in 1986 is expected to have a deleterious effect on cyclical, capital-intensive industries such as railroads and some of their most important customers. Tax reform eliminates the investment tax credit, stretches out depreciation schedules and imposes a harsh new minimum tax in years of depressed earnings.

130. Interstate Commerce Commission, Freight Commodity Statistics & Carload Waybill Statistics.

131. Statistical Analysis of Class I Railroads, Economics & Finance, AAR. (For example, there was a 43 percent increase in freight revenue ton-miles per employee-hour paid, and a 41 percent increase in freight revenue ton-miles per freight-train hour).

132. Agreements reached with the United Transportation Union. (For example, give management greater flexibility in assigning work, permit all intermodal and unit-type trains to be operated with a caboose, allow new employees to be hired at 75 percent of the wage rate paid experienced workers, phase out payment to employees for certain additional tasks assigned while on duty, and where employees are paid based upon mileage traveled, the mileage figure constituting a basic day's pay is increased by 8 percent).

133. Internal Memorandum, E&F, AAR, *supra* note 13.

134. In 1986, a typical truckload motor carrier had average ton-mile costs of 54 cents; while many rail-competitive motor carriers had whittled the figure to about 47 cents. As truckload rates fall, reflective cost reflective cost reductions, rail rates must also decline to remain competitive.

135. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085.

The railroad industry surely is not wealthy today, and the future offers only elevated financial challenges.

Sante Fe-Southern Pacific Corporation President Robert D. Krebs had this to say about railroad profitability:

Our other (non-rail) operations earn a rate of return that averages over 14 percent. Some of them get a rate of return in the 20s (while the railroads earn in the 2 to 4 percent range). So I have to ask myself—and I think you should ask yourself—why shouldn't railroads have the right to expect a decent return?¹³⁶

Railroad managements are learning to think more like business people responsible for their own destiny—to probe for more efficient ways of doing business.

So long as railroads are permitted to use the tools of capitalism, much like other businesses—especially rail competitors—it is reasonable to believe that the rail industry can achieve a viable financial future. This means, at a minimum, that railroads not again be called upon to fulfill various social welfare goals—such as being the employer of last resort—and that railroads not again be required to provide preferential treatment to special interests—such as below-market rates to coal and other favored shippers or regions.

IX. STAGGERS' EFFECT ON RAIL RATES

Market freedoms granted railroads by the Staggers Act certainly have not been used to gouge shippers. To the contrary, rail rates have compressed to meet intense competitive pressures.

From passage of the Staggers Act in October 1980 through year-end 1986, rail freight rates, adjusted for inflation, declined by 4.9 percent.¹³⁷

Under the "revenue-enhancement" provision of Staggers,¹³⁸ railroads were permitted to raise rates 6 percent per year above the inflation rate for four years (with a cumulative maximum of 18 percent), and thereafter at 4 percent without suspension or investigation by the ICC. Thus, in the first four years ending October 1984, rates could have been raised a total of 18 percent above inflation without being potentially suspended. They were not.

Increases under that authority amounted to 0.18 percent above inflation in 1981, 0.42 percent above inflation in 1982, and no increases above inflation in 1983 and 1984.¹³⁹ In both 1985 and 1986, rail rates

136. Address by Frank N. Wilner before National Association of Shippers Advisory Boards (May 8, 1985).

137. Internal Memorandum, E&F, AAR, *supra* note 13.

138. 49 USC 10707a (c) & (d), (1978).

139. Internal Memorandum, E&F, AAR, *supra* note 13.

declined.¹⁴⁰

Intermodal, intramodal, product and geographic competition are effectively constraining rail rates. While most terms of contracts are confidential, it is generally agreed that the great majority of contracts have resulted in rate reductions. Since Staggers' passage, railroads and their customers have entered into more than 50,000 contracts—with more than 62 percent of all rail-hauled coal (including 86 percent of rail-hauled coal that moves for export) and 63 percent of rail-hauled grain now moving under contract.¹⁴¹

Contract lengths vary from a single movement to more than thirty years and cover virtually all commodities hauled by rail. The existence of contracts often assures railroads a fixed volume of traffic and spells out for shippers the obligations of railroads, such as car supply and delivery schedule, as well as the manner by which rates may change in the future.

The General Accounting Office (GAO) says that "one of the most significant changes" that deregulation brought to the rail industry is "negotiated rates."¹⁴² GAO says "considerable savings" in freight rates are available when shippers and railroads enter into contracts.

A. COAL

Coal rates traditionally have been among the lowest of all rail freight rates on both a tonnage and ton-mile basis¹⁴³—even though coal is a commodity over which the railroads are alleged to have a great deal of market power.

Average rail coal rates dropped by 2 percent in 1985 and another 2.5 percent in 1986, and are now at their lowest level since 1981.¹⁴⁴ When adjusted for inflation, average rail coal rates dropped by 3.7 percent since 1980, and 6.9 percent since 1981.¹⁴⁵ Reduced world oil prices, growing availability of nuclear-generated electricity, increased competition in world coal marketed and more competition among U.S. transport modes combined to put downward pressure on those rates. The rate reductions also were made possible by reduced rail fuel and labor costs.

Increases in electric utility rates, according to figures of the Edison

140. *Id.* at 37.

141. Internal Memorandum, E&F, AAR, *supra* note 13.

142. *Grain Shipments: Agriculture Can Reduce Costs by Increased Use of Negotiated Rail Rates*, U.S. General Accounting Office (1987).

143. Much is made of the fact that, in some cases, the rail rate for moving coal comprises two-thirds of the delivered price. Those making that point omit the further fact that such cases involve low-value western coal being transported as far as 1,500 miles.

144. Internal Memorandum, E&F, AAR, *supra* note 13.

145. *Id.* at 38.

Electric Institute, have been considerably greater than increases in rail coal rates.¹⁴⁶ A study by the Congressional Research Service observed the rail revenues on coal traffic since 1971 have "increased less than the rise in either the average price of coal at the mine or the average price of electricity."¹⁴⁷

A 1987 Department of Energy study states:

The Staggers Rail Act of 1980 helped railroads to improve their own operating efficiency and to reduce costs. Lower costs have contributed to the improved financial performance of railroads and have helped to keep increases in rail rates relatively small.¹⁴⁸

Assistant Energy Secretary William Vaughan in 1985 told an audience of coal executives that:

Our analysis to date tells us that the railroads have not imposed excessive rates on coal since the passage of the Staggers Act . . . it appears that the market-oriented principles involved in the Staggers Act are contributing to the improved financial and operational health of the nation's railroads.¹⁴⁹

In a report prepared for the Environmental Protection Agency,¹⁵⁰ it was concluded, ". . . there is little evidence to suggest that deregulation is leading to widespread increases in rail rates above the underlying costs."

According to the ICC, 75 percent of rail coal traffic—measured both in carloads and tons—is priced below the 180 percent revenue-to-variable-cost threshold established by Staggers as possible evidence of market dominance.¹⁵¹

B. AGRICULTURAL PRODUCTS

A study of the seven largest grain-hauling railroads (which originate some 78 percent of rail grain traffic) revealed that the price of shipping grain by rail dropped more than 28 percent since Staggers' passage.¹⁵² When adjusted for inflation, the rate reduction exceeds 44 percent.¹⁵³ These reductions mainly are due to contract rates, the expanded use of

146. For example, from Staggers' passage in October 1980 through the third-quarter 1986, the average price of a kilowatt hour of the electricity increased by 48 percent, or 1.7 times greater than the 28 percent increase in average rail coal rates.

147. Thompson, *The Profitability of the Railroads After Enactment of the Staggers Rail Act of 1980*, Congressional Research Service (1985).

148. *Effects of Railroad Regulatory Reform on Coal and Electricity*, U.S. Department of Energy (May, 1985 draft).

149. William Vaughan, presentation of DOE and Coal Transportation, before American Mining Congress Coal Convention (1985).

150. *Transportation Rate Assumptions for Coal Market Forecasting*, ICF, Inc., (1984).

151. *1984 Rail Waybill Sample, costs determined on basis of Rail Form A.*, Interstate Commerce Commission, U.S. Government Printing Office.

152. *Annual Railroad Grain-Rate Survey, E&F, AAR.*

153. *Id.* at 40.

lower cost unit trains and a generally more competitive environment in the wake of Staggers.

A Department of Agriculture study¹⁵⁴ found substantial evidence of innovations in rail rates and service that benefited agriculture, including small agricultural shippers. The study found strong intermodal and intramodal competition in the grain-transport markets.

Two Kansas State University agricultural economists observed: Deregulation has substantially weakened rate-bureau dominance in rate matters and has enhanced individual initiative. A good deal of action/reaction ratemaking activity among railroads occurred when the Staggers Act rules were initiated. The activities of the railroads in the Central and Upper Great Plains . . . have been characterized as 'especially innovative' and providing 'significant reduction in traditional single car rates.'¹⁵⁵

C. PIGGYBACK AND CONTAINER TRAFFIC

Since the Interstate Commerce Commission totally deregulated this intermodal traffic in 1981, its growth has been phenomenal. The number of loaded trailers and containers carried by rail has increased by more than 60 percent—from just over 3 million in 1980 to more than 5 million in 1986.¹⁵⁶ In terms of carloadings, piggyback and container traffic is now second only to coal—accounting for 16.8 percent of total rail carloadings in 1986.¹⁵⁷ Total deregulation of this class of traffic—as with fresh fruits and vegetables in 1978—has permitted railroads to diffuse pricing responsibility to market managers who, working with salesmen in the field, can arrange a competitive transportation package within minutes, literally on the shipper's doorstep.

X. NEGOTIATIONS SOLVE PROBLEMS

Almost 100 years of stringent economic regulation cannot be liberalized without some difficulty. Problems between railroads and shippers, as well as among railroads, have occurred—although their frequency and magnitude have been less than expected when the Staggers Act was passed. The problems that have occurred are being solved—for the most

154. *An Assessment of Impacts on Agriculture of the Staggers Rail Act and Motor Carrier Act of 1980*, U.S. Department of Agriculture, Office of Transportation, (1982). See also, K. Casavant, *Impact of Staggers Rail Act of 1980 on United States Agriculture: An Assessment of Research Findings*, Washington State University, Department of Agricultural Economics, (1985); and S. Fuller, L. Makus & M. Taylor, *Effects of Railroad Deregulation on Export Grain Rates*, S.N. CENT. J. OF AGRIC. ECON. 1 (1983).

155. M. Chow & L. Sovenson, *Railroad Pricing in Grain Transportation Markets: A Kansas Case Study*, (1986) (Kansas State University) (Unpublished Manuscript).

156. O&M, AAR, *supra*, note 15, at 40.

157. E&F, AAR, *supra*, note 13, at 40.

part—through negotiation rather than through administrative or court proceedings.

For example, Staggers contained a "savings clause"¹⁵⁸ that permitted shippers to challenge the reasonableness of rates already on file with the ICC when Staggers was passed. Shippers filed 864 complaints, with 772 subsequently dismissed at the complainants' request—the preponderance because of negotiated settlements.¹⁵⁹

Responding to areas of unrest among certain shippers in the wake of Staggers, the ICC opened a proceeding in 1984¹⁶⁰ that is best characterized as a town meeting designed for an airing of grievances.

Two problem areas identified as deserving detailed examination were 1) the cancellation of through routes, joint rates and reciprocal switching by individual railroads ("competitive access" issues); and 2) the ICC's recognition of product and geographic competition in market-dominance determinations. Subsequently, the ICC reopened its market-dominance proceeding¹⁶¹ with respect to the consideration of product and geographic competition, and established a second proceeding¹⁶² to consider competitive-access issues.

The Commission urged railroads and shippers to attempt negotiated settlements—and agreements were reached on both these issues, with the ICC subsequently adopting them in rulemakings.

A. PRODUCT AND GEOGRAPHIC COMPETITION

The ICC's decision to consider product and geographic competition was upheld as sound by the full U.S. Fifth Circuit Court of Appeals (discussed earlier). Unrest continued among a number of shippers. According to James E. Bartley, executive vice president of the National Industrial Transportation (NIT) League—the largest and most diverse shipper organization in the nation—"Shippers were placed in the very difficult position of trying to show that these types of competition did not exist."¹⁶³

In March 1985, the AAR, NIT League and the American Paper Institute (API) announced agreement on revised standards for resolving disputes respecting market dominance. Stated Roy Olson, vice president, transportation, for API:

158. Staggers Rail Act of 1980, Pub. L. No. 96-448, 94 Stat. 1934, ss. 229.

159. In the remaining 92 cases, 61 decisions—some in favor of railroads, some in favor of shippers—were handed down; 10 were dismissed on motion of defendant railroads; and 21 remain pending for various reasons.

160. Staggers Rail Act of 1980—Conference of Interested Persons, *Ex Parte* 456.

161. Product and Geographic Competition, 2 I.C.C. 2d 1 (1985).

162. Standards for Intermodal Rail Competition, *Ex Parte* 445.

163. Interview with James E. Bartley, Executive Vice President of the National Industrial Transportation League.

The proposed rules will help to prevent misapplication of elements of geographic or product competition and better ensure railroad rate and service protection to shippers and receivers.¹⁶⁴

A key point in the agreement is the requirement that in all cases the burden of proving the existence of effective product or geographic competition rests with the railroads.

As to product competition, the ICC is to consider the substitutability and availability of alternative products and the relative costs of using alternatives—with respect to both the receiver and producer.

As to geographic competition, the ICC is to consider the number and accessibility of alternative sources of supply or alternative destinations, customer access to different carriers, relative transport costs of alternatives, operational and economic feasibility of alternatives, and evidence of long-term supply contracts made before passage of Staggers. The ICC adopted this agreement, with minor modifications, in October 1985.¹⁶⁵

B. COMPETITIVE-ACCESS

Shipper problems concerning competitive-access issues revolved around the cancellation by railroads of through routes, joint rates and reciprocal switching—as well as the establishment by the ICC of such routes and rates and other Commission actions when conflicts arise.

Cancellations are motivated by railroad desires to gain pricing independence—the right to set the rates for their own portion of a multi-carrier move. Independent pricing ensures price competition; and allows railroads to increase traffic density, eliminate inefficient routes and alter the manner in which revenues from a joint rate are divided among the participating railroads. The cancellations also were motivated by the demise of collective ratemaking.

As two Conrail executives pointed out:

The access issue is, in part, a stepchild of deregulation, which provided railroads with an expanded ability to dislodge themselves from the involuntary and uneconomic system of equalized joint rates, prescribed divisions, and below-cost switching charges. For the first time, carriers could price their services in accordance with cost and market demand.¹⁶⁶

In its deliberations on Staggers, Congress expressed concern that existing joint-rate agreements provided some connecting railroads with inadequate revenue divisions and that there was a proliferation of uneconomic routes.¹⁶⁷

164. Press Release, American Paper Institute, February 28, 1985.

165. Product and Geographic Competition, *supra* note 161.

166. Marshall & Cook, *Issues of Cost Recovery in the Debate over Competitive Access*, 15 TRANS. L.J. 10 (1986).

167. H.R. Conf. Rep. No. 96-1430, 96th Cong., 2d Sess., at 111.

Regulation prior to Staggers required equalized pricing over a multiplicity of routes, regardless of efficiency or costs. Competing railroads generally equalized rates at levels intended to be high enough to cover costs over even the least efficient routes.

According to Sam Hall Flint, retired vice president of Quaker Oats, his traffic department once calculated that between Little Rock and Detroit, there were 4.7 million different rail routes.¹⁶⁸ Obviously, the costs of, and demand for, service over all of those routes were not the same—especially the one via Los Angeles.

While railroads cancelling through routes, joint rates and reciprocal switching arrangements said that the actions were necessary to improve economic efficiency, some affected shippers complained that the cancellations unjustly eliminated their routing and pricing alternatives. According to Mr. Bartley, "To realize the Staggers Act goals of a market-disciplined industry, steps had to be taken to address the problem created by the declining number of major competitors in the railroad industry."¹⁶⁹

In January 1985, the AAR and NIT League joined hands and reached a settlement on competitive-access issues, while a second settlement with the Chemical Manufacturers Association (CMA)—generally consistent with the earlier NIT League agreement—was reached in March 1985. In September 1985, the ICC adopted, with some modifications, these agreements.¹⁷⁰

The new rules require railroads to provide notice and justification for cancellations; require an attempt at a negotiated settlement before ICC involvement; and require the Commission to suspend and investigate cancellations if a complaining shipper has or would use the rate or route for a significant portion of current or future rail needs, and the cancellation would eliminate effective rail competition.

Additionally, the rules provide for the ICC to eject a cancellation or prescribe a through route, joint rate or reciprocal switching if it finds such action necessary to prevent anti-competitive behavior. The existence of product competition will not be considered in these proceedings, while railroads will bear the burden of proving the existence of geographic competition.

Not all shippers are satisfied. A few continue to seek a legislated remedy that would force railroads to open their privately owned tracks (the railroads' factory) for use by others at rates to be established, ulti-

168. Address by Sam Hall Flint, Vice President of Quaker Oats Corp. (retired), Southern Traffic League (Sept. 11, 1984).

169. Interview with James E. Bartley, *supra* note 163, at 44.

170. *Intramodal Rail Competition*, 1 I.C.C. 2d 822, 823 (1985).

mately, by federal courts.¹⁷¹ Railroads would be subject to dual regulation—by both the Interstate Commerce Commission and federal courts, subjecting them to a regulatory nightmare affection no other American industry.

The proposed legislation would seek to create new principles of anti-trust law specifically aimed at railroads—to force railroads to open their plant to use by others or face antitrust penalties. The railroads see this as an unjust taking of private property—a taking without adequate compensation (under the principle controlling in condemnation proceedings) because the purpose of the legislation clearly is to force many rail rates to levels that would not cover the full costs of the service demanded.

While a technical discussion of railroad economics is beyond the scope of this article, it should be recognized that over much of the railroads' lines—and certainly on a system basis for all major railroads—economies of density exist.¹⁷² This means that the cost of moving each additional carload (marginal cost) is somewhat less than the average of moving all carloads (average cost). Any requirement that rail rates be forced to the level of marginal costs is a prescription for railroad bankruptcies.

C. CONFIDENTIAL CONTRACTS

As explained earlier, one of the most successful provisions of the Staggers Act was the ability of railroads to enter into confidential contracts with their customers.

Some grain, soybean and sunflower-seed shippers,¹⁷³ however, sought greater regulatory protection through increased public disclosure of contract terms. They maintained that contract confidentiality prevents their right—under Staggers¹⁷⁴—to obtain contract rates and services substantially similar to those of a competitor. Other grain, soybean and sunflower-seed shippers, however, strongly supported continued contract confidentiality.

In October 1985, following negotiations with the National Grain and Feed Association—which represents some 1,250 grain and feed compa-

171. S. 443, and H.R. 941, 100th cong., 1st Sess. (1987).

172. T. Keeler, *Railroads, Freight and Public Policy*, (Brookings Institution, 1983), at 43-48; see also A. Kahn, *The Economics of Regulation II*, (1971), at 116-126.

173. All farm products *except* grain, soybeans and sunflower seeds are exempt from economic regulation.

174. Section 10713 of Staggers permits the ICC to make public certain contract information to afford shippers the ability to challenge a contract on the grounds that it will impair the ability of the contracting railroad(s) to meet their common-carrier obligations to the complainant (Section 11101). Agricultural shippers only (Section 10713(d)(2)(B)(i)) may challenge a rail contract on the grounds that the contracting railroad has refused to enter into a substantially similar contract with them, or that the contract constitutes a destructive competitive practice.

nies—the railroads agreed on more explicit contract-disclosure rules affecting raw grains and soybeans. The agreement, like those with the NIT League, API and CMA was submitted to the ICC for adoption—which expanded it in many ways, neither contemplated nor desired by the railroads or many shippers. Because of this, the ICC sought another round of public comment.

In the interim, as part of the October 1986 Conrail Privatization Act, Congress directed the ICC to liberalize its contract-disclosure rules as they affect shippers of grain, soybeans and sunflower seeds.¹⁷⁵

To meet Congress' timetable, the ICC issued interim rules¹⁷⁶—effective January 22, 1987—that went beyond the minimum additional disclosure ordered by Congress. The ICC also sought additional public comment before making the new rules final. (As of this writing, final rules have not been issued.)

A sizeable segment of the agricultural community opposes greater contract disclosure. A coalition of major grain shippers say that "a small but vocal minority of the agricultural community" has been "unwilling to make the commitment necessary to realize the full benefit of rail contract transportation."¹⁷⁷

At the ICC, a survey was taken among small, medium and large grain, soybean and sunflower-seed elevator operators, along with representative feed mills and grain marketing firms. A major conclusion was:

Many small country elevators are disadvantaged by the high-volume railroad contract rates of competing larger elevators. However, even if contract rates were not available, these small elevators would still be disadvantaged by the existing railroad tariff rate structure which provides substantially reduced rates for the larger multiple car and unit-train shipments.¹⁷⁸

Lack of volume was most often cited as a reason for not having a contract. Many elevator operators claiming to be disadvantaged had refused to make investments in volume loading facilities, even though they had invested to otherwise enlarge their facilities to handle increased government-subsidized grain storage.

The survey made clear that, overall, farmers have benefited from

175. Omnibus Budget Reconciliation Act of 1986, Pub. L. No. 99-509, 100 Stat. 1910, SS. 4051. Congress ordered the I.C.C. to ensure that, at a minimum, the following information be disclosed on certain agricultural-shipper contracts: identity of the shipper as well as specific origins, destinations and transit pints; the duration of the agreement; volume requirements; the date the service began; and the date the contract became applicable.

176. *Ex Parte* 387, December 19, 1986. See also Wastler, *I.C.C. Installs New Disclosure Rules for Rail Transportation Contracts*, 11 TRAFFIC WORLD 209, (Dec. 29, 1986).

177. *Grain Shippers Ask I.C.C. to Delay Contract Rules*, DAILY TRANSPORTATION REPORT (Dec. 4, 1986).

178. *Contract Rate Competitive Impact Report-Grain Shippers*, Contract Rate Advisory Service, Office of Transportation Analysis, Interstate Commerce Commission, Feb. 8, 1987.

confidential rail contracts through higher prices being paid them for their harvest. Indeed, it is common for farmers to truck large quantities of grain to more distant, high volume elevators in search of higher prices for their grains, soybeans and sunflower seeds.

XI. POSITIVE PERCEPTIONS

In a nationally syndicated column, economics writer Warren Brookes observed that, "In short, the Staggers deregulation has been a monumental success, restoring the once bankrupt U.S. railroad industry to modes profitability, while benefiting shippers and consumers with more competitive rates."¹⁷⁹

ICC economist Christopher Barnekov suggest that the benefits of deregulation are so widely disbursed and that the beneficiaries are so busy minding their own businesses that they have not sought out media attention or traveled to Washington to tell their story.¹⁸⁰ Dr. Barnekov states: "It is not in most companies' interests to reveal to their competitors (or their customers) how much their logistics costs have fallen."

A few very vocal special-interest pleaders—those who believe they could gain greater competitive advantages themselves under continued strict economic regulation—have amplified their voices through various coalitions. However, even the most critical opponents of Staggers Act freedoms have been unable to point to any railroad abuses since passage of the Act.¹⁸¹ Complaints are based upon fear—fear that in a less regulated environment abuses might occur.

Electric utility interests—clearly the most vocal of special interests opposing railroad market freedoms—have, in fact, acknowledged significant transportation-dollar savings flowing to them since Staggers. A survey identified many electric utility press releases, annual reports and public comments crediting negotiated rail-transportation contracts—all growing out of Staggers—with saving utility customer's millions and even hundred of millions of dollars.¹⁸²

A December 1986 nationwide random sample of rail shippers reveals that 72 percent of those polled view railroads—since passage of the Staggers Act—more dependable in keeping schedules, more responsive to customer needs and concerns, and more reliable in

179. C. Barkenov, *A Look at Two Faces of Railroad Regulation*, 7 *TRAFFIC WORLD* 207 (Aug. 18, 1986), at 86, 89; R.V. Delaney, printed remarks before the National Industrial Transportation League (Nov. 10, 1986).

180. *Id.* at 49.

181. At the ICC 1984 "town meetings," described earlier, shippers were unable to offer a single example of ratemaking abuse, even though the ICC proceeding was instituted as a forum for them to do so.

182. Information and Public Affairs Department, American Association of Railroads.

performance.¹⁸³

In a *Wall Street Journal* opinion article, a former general counsel of the ICC and an assistant to a current ICC commissioner wrote:

The new law seems to be working as intended. Staggers was enacted because the existing regulatory scheme had failed conspicuously . . . problems are those of bad communication rather than commercial oppression.¹⁸⁴

Said Senator John C. Danforth, chairman of the Senate Commerce Committee until 1987, "I don't believe that the Staggers Act should be altered. It's been the salvation of the railroads."¹⁸⁵

A former vice chairman of the Civil Aeronautics Board, who is currently dean of the Graduate School of Industrial Administration at Carnegie Mellon University, observed:

Perhaps the chief benefit of deregulation is that it has increased efficiency substantially. Under regulation, there was little incentive to plan or to pinpoint the sources of markets that were successful and those that were failure, or to keep costs under control and be responsive to consumer demands.

In contrast, deregulation is leading to substantially more efficient industries, in which cross-subsidy is absent, a diversity of price-service options is present, and cost-minimizing behavior is prevalent, both in delivery systems and in other operation costs.¹⁸⁶

Concerned that a small minority of disgruntled shippers might cause the Staggers Act to be amended so as to insulate special-interest groups from workings of the marketplace, a shippers group has been established to oppose any changes to Staggers.

The Committee Against Revising Staggers (CARS) is made up of more than 300 shippers from each of the contiguous states and the District of Columbia—self-described as large and small, bulk and non-bulk, captive and non-captive.

Some of the larger members of CARS include the American Retail Federation, Archer Daniels Midland, Bethlehem Steel, Carnation, Continental Grain, Crown Zellerbach, General Motors, Georgia Pacific, Kenne-cott, Procter and Gamble, Quaker Oats, and Sears. Stated CARS in a press release:

Staggers has been the one leading factor contributing to the financial revival of the American railway system and saving consumers millions in transportation costs during the last four years.

183. Hamilton, Frederick & Schneiders, A nationwide Survey of Opinions of Upper-Income individuals and Shippers Toward America's Freight Rail Industry (public opinion research under contract to AAR.) (Jan., 1987).

184. D. Campbell & J. Broadley, *Assault on Rail Deregulation Gains Steam*, Wall St. J., Oct. 4, 1984.

185. *Voice of Commerce: Committee Chairman Danforth Makes Himself Heard on the Issues From Autos to Beer Ads*, FORTUNE, June 24, 1985.

186. E.F. Bailey, *Deregulation: Causes and Consequences*, SCIENCE, Dec. 5, 1986, at 1216.

Stanton P. Sender, a CARS organizer and transportation counsel for Sears, observed:

Staggers is working as intended for the shippers and consumer. The efficiency and reliability of shipping goods by rail has improved dramatically since 1980, thus holding down shipping costs which would be passed along to the public.¹⁸⁷

In June 1985, the Transportation Investor Roundtable—a nationwide group of investor executives—issued a statement warning:

We believe that the threat of changes in the Staggers Rail Act, or even the fine-tuning of the Act, could quickly destroy today's renewed confidence in the industry. Without his confidence, the economy as well as the nation's competitive position in world markets would be at risk from a weakening of its railroad structure.¹⁸⁸

Fifty-six economists—including two Nobel laureates, former members of the President's Council of Economic Advisers, three past presidents of the American Economic Association, and many well-known authors—have gone on record in support of Staggers.

In a jointly signed letter, they stated:

. . . the Staggers Act has brought about a regulatory regime much more attuned to the state of competition than now exists . . . was part of a broad, long-term effort to eliminate inefficient economic regulation . . . (that) has often failed to serve the interest of the public at large.¹⁸⁹

Other major supporters of Staggers include the Grocery Manufacturers of America, the National Taxpayers Union and the American Farm Bureau Federation. The farm group has accused coal and electric utility interest—who are lobbying for changes in Staggers—of “seeking to avoid” their full share of the costs of the rail system upon which they claim to be totally dependent. Observed *Forbes* magazine of efforts to reregulate the railroads:

A sorry spectacle. The whole affair is an embarrassment to free enterprisers. A lot of business people who give lip service to free markets and to deregulation are trampling on their own principles in the hope of a monetary advantage.¹⁹⁰

Isabel H. Benham, described by *Forbes* as the “dean of U.S. railroad analysts,” explained:

This act (Staggers) gave freedom to the railroads in ratemaking, routing, abandonments, marketing and creating of unit trains, and no railroad in the country has benefited as much as Conrail has. Deregulation provided the marketing tools to compete with the trucker—rates can be changed within

187. F.N. Wilner before National Industrial Transportation League, April 12, 1985.

188. Statement of June 5, 1985. Signed by W.W. Bixby, coordinator; H.H. Livingston, chairman; and I.H. Benham, chairman, railroad liaison team.

189. Statement of February 25, 1985. Economists include D.J. Arrow, W.J. Baumol, H.S. Houthakker, L. Thurrow, J. Tobin, G. Ackley, G.C. Eads, G.W. Hilton & P.W. McCracken.

190. *Profits over Principle*, FORBES, March 25, 1985.

hours instead of months—and since Conrail is probably the most truck-sensitive railroad in the country, this has been a major boon.

I'm so very optimistic. However, if there is any fine-tuning of the Staggers Act or if it is repealed, then Conrail, and probably every other railroad in the whole country, is doomed. In my opinion, the viability of Conrail and the preservation of the Staggers Act are inextricably interlined.¹⁹¹

In a recent editorial, following Conrail's return to the private sector, *Barron's* publisher Robert M. Bleiberg concluded, "Don't derail progress. Moves to reregulate should be stopped in their tracks."¹⁹²

XII. THE STUFF OF FREE MARKETS

Clearly, the Staggers Rail Act is working as intended—for railroads, for shippers and certainly for society.

Staggers is working as intended because rail service has improved. The array of price/service options available to shippers has increased. Many rail rates have declined. Overall, rail rate levels are not rising as fast as they were previous to the Act's passage. In fact, as indicated in an earlier section, overall rail rates actually have declined in real terms.

Staggers is working as intended because greater reliance is being placed upon free markets.

Under stringent economic regulation, buyers of rail transportation often couldn't buy all they sought—at any price—and sellers often found themselves with excess capacity that they couldn't sell—at any price.

Events of the 19th Century that led to creation of the Interstate Commerce Commission in 1887 have given way to competitive realities of the late 20th Century. Today, the vast preponderance of all rail freight service faces intense competition, from modes that evolved and expanded well after the rail regulatory system was conceived, as well as from other railroads.¹⁹³

Deregulation has permitted railroads to use the tools of the free-market—contract, market-induced price reductions and increases, product-line expansions and contractions—to better meet the varied wants of the marketplace. In the words of Oregon Senator Bob Packwood, "There is no reason why we should be controlling capitalistic acts by consenting adults."¹⁹⁴

Opponents of rail deregulation ignore its positive results. Instead of focusing upon efficiency gains stemming from less government involve-

191. *Who Gets Conrail*, FORBES, Aug. 26, 1985.

192. BARRON'S, April 13, 1987, at 2.

193. M. Levin & B. Stram, *Nursing the Railroads Back to Health*, REGULATION, Sept.-Oct. 1981, at 29.

194. *Senate Panel Sends Truck Bill to Floor*, Congressional Quarterly, March 15, 1980, at 753.

ment, they incorrectly focus on the number of rail suppliers serving a fixed point. They assert that railroads—despite the existence of intramodal, intermodal, product and geographic competition—remain a transportation monopoly requiring continued economic regulation.

In fact, the vast number of beneficiaries of rail deregulation are too busy reaping the widely dispersed benefits to broadcast their gains. It is a minority of unhappy shippers—unhappy not because they can show railroad abuse of market freedoms, but because they believe they can gain a better deal under strict regulation—who are spending a disproportionate amount of resources seeking alterations. It is almost exclusively the minority voice that is being heard on Capitol Hill.

The fact is, however, that railroads no longer are monopolies. Every business has some limited market power. The corner gas station has market power on the corner it serves, as does the supermarket or drug-store on the block it serves. What distinguishes these enterprises from monopolies is that other sellers can compete on another corner or on the next block.

So it is with railroads. Though the Burlington Northern (BN) appears to have market power in some North Dakota towns, the BN does not have a monopoly. This is because the Soo Line sells a similar railroad service in nearby towns, and because substitute motor-carrier service can be obtained in every North Dakota town—and because it is in BN's self-interest to assure that shippers located on its lines can compete with shippers located on other rail lines.

Though the Norfolk Southern (NS) appears to have market power over coal shipments from Southwest Virginia in West Virginia, NS does not have a monopoly. This is because electric utilities and steel mills buying steam and choking coal in the NS region can purchase it from mines located on Chessie or Conrail lines, or substitute barge for rail.¹⁹⁵ Again, NS and its shippers are in partnership to assure that the coal they mine and carry can compete.

Coal-hauling railroads face additional competitive pressures because of the ability of utilities they serve to purchase foreign-produced coal; to build future power plants at the seashore or on rivers; to substitute natural gas, fuel oil or nuclear power for coal; or to buy surplus generating ca-

195. Virginia Power, for example, has begun barging coal from Norfolk to a power station on the James River near Richmond. If rail rates from the coal fields via NS to Norfolk are perceived to be "too high," Virginia Power can move coal from other mines via Chessie to Newport News or Baltimore, or via Conrail to Philadelphia—all for subsequent barging. New England Energy has used similar tactics to create competition—even going to foreign-produced coal and completely bypassing the U.S. rail network. *Utility Tests Barging of Coal*, *Journal of Commerce*, Nov. 25, 1985.

capacity from other utilities served by other railroads or barges.¹⁹⁶

Competition does have a price—the price to buyers of finding alternatives. Sadly, almost a century of economic regulation has left many buyers of freight transportation unprepared for the basic comparison shopping that characterizes all of our other business decisions.

Railroads have not been totally deregulated. If railroads charge non-competitive prices, there are regulatory avenues still available to curb abuse. The fact is, however, that even before regulatory relief arrives, the offending railroad(s) most probably will see existing and potential traffic move via other modes; traffic evaporates as substitute products are found; or traffic disappears as buyers secure their products from other geographic areas served by other railroads.

Railroads are generally as vulnerable to a loss of business resulting from non-competitive pricing practices as are corner gas stations, supermarkets or drugstores.

The proper measurement of successful public policy is the excess of benefits over costs. The free-market tenets of Staggers have dramatically increased public benefits and markedly reduced public costs.

XIII. CONCLUSION

It was barely a decade ago that more than 21 percent of the nation's rail mileage was mired in bankruptcy. Some 47,000 miles of track, suffering deferred maintenance, were restricted to speeds of as slow as 10 miles per hour. Freight-car and locomotive shortages were common. Transit times were inconsistent; loss and damage claims high.

A steady erosion of rail business to other modes had pushed the railroads' share of intercity freight tonnage to less than 37 percent; and the railroads' share of intercity freight revenues to below 18 percent. Still, federal and state government continued to regulate railroads as if they were a monopoly.

Rail-competitive motor carriers and barge operators—favored with substantially less economic regulation—enjoyed greater flexibility in pricing and marketing, allowing them to siphon the railroads' business with impunity. And since truck and barge operators enjoy subsidies in the form of government constructed and maintained rights-of-way—with user

196. The electric utility industry can produce at least 36 percent more peak-load power than it sells—growing to 50 percent by the end of the decade. In 1986, Metropolitan Edison began periodically closing its Reading, Pa., coal-fired generating station and began purchasing nuclear generated electricity from Philadelphia Electric Co. According to the National Coal Assn., "Coal companies in domestic markets are finding it difficult to compete with oil and gas and nuclear power." *Why Cheaper Electricity May be on the Way to Consumers*, BUSINESS WEEK, Oct. 29, 1984; Statement by Jerome Karaganis, Vice President, Economics, National Coal Association in Coal Age, April, 1987, at 11.

charge levels far below cost recovery levels—these competitors often offer lower rates than railroads, which have no such subsidies. Economic efficiency is not served when freight allocation is made on the basis of taxpayer subsidies rather than inherent advantage.

Regulatory delay made it increasingly difficult for railroads to adjust their prices and service to market conditions, to abandon money-losing track, or shed unprofitable lines of business. Social-welfare objectives—requiring railroads to grant preferential treatment to certain producers, ports and regions, and to act as employer of last resort—received greater weight in regulatory hearings than the railroads' need for adequate revenues.

Throughout the early and mid-1970s, Congress attempted a series of "Band-Aid" approaches, directed more at the symptoms of the railroad decline rather than the causes. The "Band-Aid" solutions, predictably, were not successful.

The fear of additional rail bankruptcies, the specter of nationalization and a recognition that tax dollars are scarce all combined to focus Congress on the fact that government interference was causing massive inefficiencies among transportation modes. As the decade of the 1970s came to a close, Congress acknowledged that bureaucracies are ill-equipped for central planning; that free markets are the most efficient and the most equitable.

Thus, in 1980, Congress ought to treat railroads more like other businesses. It passed the Staggers Rail Act, which provided railroads with a healthy dose of deregulation. The principal goal of the Staggers Act was to preserve a viable private-sector rail system, relying to the fullest extent possible on market forces. Regulation was to remain in effect only where necessary to prevent abuses of market power.

Since passage of Staggers, deferred maintenance on mainline track virtually has been eliminated. The railroads' safety record has improved substantially. Freight loss and damage payouts are at an all-time low. Equipment shortages have given way to equipment surpluses. Productivity has been improving; operating costs falling. Where trains once lurched at ten m.p.h., many now travel at seventy m.p.h., with arrival times guaranteed. Investment in research and development is at record levels.

Many rail rates have been dropping. Overall, rail rates are rising far less rapidly than they did prior to the Act's passage. In fact, average rail rates—when adjusted for inflation—have declined by almost 5 percent since passage of the Staggers Act. More than 60 percent of the coal and grain hauled by railroad moves under contracts negotiated between railroads and their customers. In many markets, railroads are now compet-

ing more successfully against trucks and barges—though rights-of-way subsidies to those modes continue to keep the playing field uneven.

Rail profits still lag the level of profits enjoyed by American industry in general and are still well below the revenue adequacy test employed by every other business. Those substandard profits may be further battered as America completes its shift from a primarily industrial-based nation to one of greater service concentration. However, it has been the marketing freedoms bestowed by Staggers that permitted railroads to weather a long and deep recession, and the fundamental changes in the economy that are taking place.

Optimism runs high among rail management that the nation's rail system can be rationalized within the private sector to meet the changing economic environment. More competitive labor contracts and creation of regional and short line railroads out of previously uneconomic rail lines is evidence of such progress.

Completion of the rationalization task—which will increase traffic densities, further pare operating costs and position railroads to compete more aggressively for business now moving by highway—is dependent upon retention of the marketing freedoms granted by the Staggers Act.

The overwhelming majority of rail shippers praise the results of rail deregulation, which is reflected in more competitive rates, and restoration of reliable and consistent service. A host of studies, many by government agencies and other neutral observers, confirm that railroads are not abusing their market freedoms.

Where problems have developed with shippers, good faith negotiations are resulting in equitable solutions. Still, a minority of shippers are demanding reregulation of the railroads—convinced they can gain a "better deal" for themselves from regulators. The voice of this minority has been amplified because the overwhelming majority of shippers who have benefited from deregulation are busy tending to their own businesses. A group of more than 300 satisfied shippers has been formed, however, to counter the lobbying activities of the mostly coal and electric utility shippers who are complaining.

Data and events make very clear that the Staggers Act is the most successful transportation legislation ever passed by Congress. After years of trying to survive in Washington, rail managers are learning to survive in the marketplace.