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ECONOMIC REGULATION OF BUSINESS: THE SEVENTH CIRCUIT'S NON-ECONOMIC APPROACH

MARK R. LEE*

Major business decisions are ordinarily responsive to the rewards offered and the penalties imposed by the marketplace. Those rewards and penalties reflect aggregate consumer preferences, the cost of productive inputs and the like—in short, market forces. These market forces are instrumental in serving economic efficiency. Indeed, we routinely rely upon market forces to guide business decisions so that all who are willing to pay the cost of a service are supplied; so that sellers are induced to improve quality; and so that resources are put to their most valuable use. In some sectors of the economy, including railroading, trucking, and natural gas transportation, however, the Congress has interposed laws between market forces and major business decisions. These regulatory laws, along with their complementary administrative agencies and rules, purportedly may function either to promote or compromise economic efficiency. Those that would promote efficiency establish principles and institutions designed to preserve it by correcting market imperfections. Those which would compromise efficiency create mechanisms designed to sacrifice some of it by protecting from competitive erosion a portion of the income of existing market participants. The function to be served by these regulatory laws ought to be a court's touchstone when a court is called upon to interpret them.

When resolving regulatory cases, a court should explain its decisions in terms of the functions of the applicable laws. The United States Court of Appeals for the Seventh Circuit should have done so in the four major regulatory opinions it issued during the 1978-79 term.¹ Explaining decisions in these terms is not easy, however, for three obstacles loom large. First, the cases tend to be of great complexity and difficulty, frequently involving highly specialized and technical areas of knowledge. The Seventh Circuit, for example, had to cope with the

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1. *Natural Gas Pipeline Co. v. Federal Energy Reg. Comm'n*, 590 F.2d 664 (7th Cir. 1979); *Illinois v. Consolidated Rail Corp.*, 589 F.2d 1327 (7th Cir. 1978), *cert. denied*, 99 S. Ct. 2884 (1979); *Niedert Motor Service, Inc. v. United States*, 583 F.2d 954 (7th Cir. 1978); *Chicago & North Western Transp. Co. v. United States*, 582 F.2d 1043 (7th Cir. 1978).

intricate problems of abandonment of railway lines² and discontinuance of service by railroads,³ entry by a trucking firm into a new market,⁴ and the overall price level for the transportation of natural gas.⁵ Second, courts must be sensitive to the institutional competence of administrative agencies. Third, few judges are conversant with economic analysis and fewer still are comfortable with it. Yet, unless these obstacles are surmounted neither the principles underlying regulatory decisions nor the reasoning which supports them can be very clear. Moreover, predicating the outcome of future decisions becomes highly problematic, frustrating the tasks of both lawyers and agencies. The 1978-79 opinions of the Seventh Circuit reviewed here, unfortunately, made little contribution towards clarity or predictability.

BRANCH LINE ABANDONMENT UNDER THE RAILROAD REVITALIZATION AND REGULATORY REFORM ACT OF 1976

In *Chicago & North Western Transportation Co. v. United States*,⁶ the Seventh Circuit reviewed Interstate Commerce Commission⁷ regulations that set forth⁸ the method by which the ICC would assess the cost responsibility of railroad branch line operations threatened with abandonment⁹ and the responses the ICC might have made to the fail-

2. *Chicago & North Western Transp. Co. v. United States*, 582 F.2d 1043 (7th Cir. 1978).

3. *Illinois v. Consolidated Rail Corp.*, 589 F.2d 1327 (7th Cir. 1978), *cert. denied*, 99 S. Ct. 2884 (1979).

4. *Niedert Motor Service, Inc. v. United States*, 583 F.2d 954 (7th Cir. 1978).

5. *Natural Gas Pipeline Co. v. Federal Energy Reg. Comm'n*, 590 F.2d 664 (7th Cir. 1979).

6. 582 F.2d 1043 (7th Cir. 1978).

7. Hereinafter referred to as the ICC.

8. The court also reviewed ICC regulations that (a) required that petitions to investigate proposed abandonments be verified and filed within 35 days of the filing date of the railroad's abandonment application, 49 C.F.R. §§ 1121.36(a)(1), 1121.36(c)(1) (1977); and (b) prescribed the revenue data that a railroad proposing abandonment had to submit along with its abandonment application, 49 C.F.R. § 1121.32(d) (1977) (this regulation referred to another establishing the method of attributing revenues to branch lines; see 49 C.F.R. § 1121.46 (1977)). The regulations pertaining to petitions to investigate were challenged by, among others, the American Railway Supervisors' Association, a labor union, as inconsistent with the provisions relating to such petitions in the statute governing railroad abandonments. See 49 U.S.C. § 10904(a) (Supp. 1979) (a reenactment of what was then 49 U.S.C. § 1a(1)-(3) (1976)). The regulations pertaining to revenue data were challenged by the Commonwealth of Pennsylvania as implicitly overruling, without adequate explanation, the so-called "50 per cent rule." The 50 per cent rule was an arbitrary method of attributing to the branch line the costs of rail operations conducted on and off the branch line, a method that had occasionally been used by the Commission in abandonment proceedings. Both challenges were easily brushed aside by the court, but the court omitted to explain what it was doing in terms of the economic function of the applicable statute. See 582 F.2d at 1058-61.

9. 49 C.F.R. §§ 1121.42(b), 1121.42(c)(4), 1121.42(c)(6), 1121.42(l), 1121.42(m), 1121.44 (1977). 49 C.F.R. § 1121.44 (1977), the last of those regulations listed, fixed the return on the value of a branch line owned by a railroad in reorganization for which branch line operations would be held responsible. It fixed that return as equal to the "average yield on all railroad bonds

ure by a railroad proposing abandonment and a potential subsidizer opposing it to reach a subsidy/continuation agreement.¹⁰ The court invalidated most of the regulations,¹¹ thereby making it easier for railroads to shed unprofitable operations and, perhaps, more expensive for subsidizers to support such operations.

Background

Generally, unregulated railroads would decide to abandon branch lines whenever they expected to maximize their net revenues from doing so or whenever the railroads expected their gains to exceed their losses. To such railroads, the gains would include not only saved operating expenses but also earnings on redeployed resources and reinvested capital; the losses would consist principally of foregone revenues. We would expect, therefore, that an abandonment decision which would appear to an unregulated railroad to maximize net revenue would also appear to society to be economically efficient.¹²

Nevertheless, railroad decisions to abandon branch lines have long been subject to review by the ICC.¹³ The function of that review has not been to promote efficiency.¹⁴ Indeed, before approving an abandonment, the ICC has consistently balanced efficiency against the im-

for the week immediately preceding the execution of the subsidy agreement, as quoted by any standard investors' service" *Id.* at § 1121.44(b). The court found this regulation linguistically incompatible with 49 U.S.C. § 10905(a)(2)(b) (Supp. 1979) (a reenactment of what was then 49 U.S.C. § 1a(11)(b) (1976)). That law provided for a return equal to "the mean cost of capital of railroads not in reorganization." 582 F.2d at 1056-57, *citing* 49 U.S.C. § 1a(11)(b) (1976).

10. 49 C.F.R. § 1121.38(i)(2) (1977).

11. 582 F.2d at 1048-58.

12. The equivalence in gains and losses would not hold with respect to a branch line abandonment by an ineffectively regulated railroad that enjoyed a monopoly in transportation service between the points served by that branch line. The equivalence would not hold in that exceptional circumstance since certain effects of the abandonment, like the reduction in supra-competitive revenues, would be considered a loss by the railroad but not by society. The exceptional circumstance may be safely ignored, however, for two reasons. First, it may be ignored because we are concerned about prohibiting an abandonment that a railroad proposes and a railroad that found itself in that exceptional circumstance would be less inclined than other railroads to propose one. Second, the exceptional circumstance may be ignored because it is unlikely to be observed in the work-a-day world in which trucks and trucking service are so available. S. REP. NO. 499, 94th Cong., 2d Sess. (1975), *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 14.

13. The ICC has had power over abandonments since at least 1920. 41 Stat. 477 (1920).

14. Theoretically, the ICC could review abandonment decisions in order to promote efficiency. Rail service might confer benefits for which the railroad would be unable to obtain payment from its ordinary ratepayers. Those benefits might be bestowed on so many and such a varied lot of recipients that the railroad could not effectively negotiate with them. Thus, the decision to abandon might appear revenue-maximizing to the railroad but inefficient to society (the marginal revenue might be less than the marginal benefit of the service). The ICC might then veto the decision to abandon as inefficient. Actually, the ICC has never so justified an order prohibiting abandonment. Moreover, it is not at all clear that significant external benefits are associated with rail service. If they were, they might be offset by significant external costs.

mediate loss of income likely to be suffered by railroad patrons situated near the affected branch line and their employees and customers. When the ICC has reckoned the benefits of efficiency, small compared with the costs of lost income, it has sometimes sacrificed the former for the latter and vetoed abandonment.¹⁵

Congress was apparently less than satisfied with the balance struck by the ICC.¹⁶ As a result, Congress enacted section 1a of the Railroad Revitalization and Regulatory Reform Act of 1976.¹⁷ Section 1a¹⁸ replaced and significantly amended the Interstate Commerce Act provisions governing abandonment.¹⁹ Section 1a established a two-stage process for the disposition of proposed line abandonments. During the first stage, the ICC must determine whether the "present or future public convenience and necessity require or permit such abandonment" ²⁰ In so deciding, it must "consider whether there will be a serious adverse impact on rural and community development by such abandonment."²¹ If the ICC finds that abandonment would serve the public convenience and necessity and should, therefore, be certified, the ICC must publish its findings in the Federal Register.²² The first stage appears to be substantially similar to the repealed provisions of the Interstate Commerce Act,²³ but the second stage, which is entered only if the ICC finds that abandonment should be certified, is entirely new.

15. *Colorado v. United States*, 271 U.S. 153, 169 (1926); *Norfolk Southern Rwy. Co. Abandonment*, 282 I.C.C. 376 (1952); W.K. JONES, *REGULATED INDUSTRIES* (2d ed. 1976) 420-23. Preventing certain branch line abandonments could also be justified, at least in theory, as a means of distributing what would otherwise be monopoly revenues (what is often called the "consumer surplus"). Consider this example. Suppose that Robber Barron Railroad Co. provides service over two main lines and numerous branch lines. Absent regulation, it would charge all of its customers rates that would exceed, by different amounts, the costs for which they were causally responsible. Suppose that Robber Barron would then earn \$100,000,000. But Robber Barron is regulated by the ICC; it might want to limit Robber Barron's total revenues to \$90,000,000. To do that, the ICC would have to control Robber Barron's rates. It would have to, in effect, distribute \$10 million in monopoly revenues. The ICC might distribute the monopoly revenues in such a way that the shippers served by one particular branch line would be charged rates that would not cover the costs for which they are causally responsible. If Robber Barron were then permitted to abandon that branch line, it could, to a degree, successfully evade the ICC's attempt to limit its total revenues. To prevent that, the ICC might veto the abandonment. The general problem of what to do with consumer surplus afflicts virtually all rate regulating administrative agencies.

16. See 45 U.S.C. § 801(b) (Supp. 1979).

17. 49 U.S.C. § 1a (1976).

18. *Id.* After the opinion in *Chicago & North Western Transp. Co.* was published, the Congress recodified and reenacted the Interstate Commerce Act. What was section 1a is now part of 49 U.S.C. §§ 10903-10906 (Supp. 1979). For convenience and to facilitate comparison of this analysis with the case, what was section 1a will still be referred to herein as section 1a.

19. *Id.* § 1a (1976) (current version at *id.* §§ 10903-10906 (Supp. 1979)).

20. *Id.* § 1a(1) (1976) (current version at *id.* § 10903(a) (Supp. 1979)).

21. *Id.* § 1a(4) (1976) (current version at *id.* § 10903(a) (Supp. 1979)).

22. *Id.* § 10905(b) (Supp. 1979). See 582 F.2d at 1047.

23. 49 U.S.C. § 1(18)-(22) (1973).

During the second stage, the ICC must determine whether a financially responsible entity has offered the railroad, in return for non-abandonment, compensation in an amount likely to "cover the difference between the revenues . . . attributable to [the particular] line . . . and the avoidable cost of providing . . . freight service on [the] line, together with a reasonable return on the value of [the] line."²⁴ Upon an affirmative determination, the ICC must delay issuing its certificate for a "reasonable time, not to exceed 6 months, as is necessary to enable such . . . entity to enter into a binding agreement, with the carrier seeking such abandonment" ²⁵ If the parties should reach an agreement, the ICC must again delay issuing its certificate for the duration of the agreement.²⁶ This two-stage process connects abandonment review with subsidy/continuation negotiations and involves the ICC in those negotiations.

This connection and the ICC's involvement could be expected to reinforce the ICC's awareness that the income of those dependent on branch lines could be protected through subsidized continuation, as well as through the veto of abandonments. That awareness could be expected, in turn, to make the ICC more willing to approve abandonments. Section 1a, then, seems calculated to change the pattern of ICC decisions without withdrawing railroad abandonments from ICC review. Apparently, it is the function of the section to tilt toward efficiency the scales used by the ICC to weigh efficiency and lost income, thereby striking a new balance more satisfactory to the Congress.

The Branch Line Cost Responsibility Regulations

To discharge its duties at each stage of the section 1a process, the ICC must assess the costs for which rail operations on a branch line are to be held responsible. In railroad parlance, those costs are called "avoidable costs."²⁷ The ICC must assess these costs because it needs to measure the difference between them and branch line revenues.²⁸ That difference is both the best measure of the efficiency gains from abandonment, a key consideration at stage one, and the statutorily

24. *Id.* § 1a(6)(a) (1976) (current version at *id.* § 10905(b)(2)(A) (Supp. 1979)). Alternatively, the financially responsible entity may offer to purchase the branch line. *Id.* § 1a(6)(b) (1976) (current version at *id.* § 10905(b)(2)(B) (Supp. 1979)).

25. *Id.* § 1a(6) (1976) (current version at *id.* § 10905(b) (Supp. 1979)).

26. *Id.*

27. Price & Berardino, *Defining Economic Terms Used in the Railroad Revitalization and Regulatory Reform Act*, 9 TRANSP. L.J. 133, 154-58 (1977) (hereinafter referred to as Price & Berardino).

28. 49 U.S.C. § 1a(6)(a)(ii)(A) (1976). See Price & Berardino, *supra* note 27, at 134.

mandated measure of the adequacy of a subsidy/continuation offer, the only issue at stage two. Not surprisingly, the ICC has chosen, for reasons of administrative convenience, to use the same assessment method for the purposes of each stage.²⁹ Thus, the assessment of avoidable costs bears heavily on a railroad's ability to abandon burdensome branch lines and on the level of compensation likely to be required of a potential continuation subsidizer.³⁰

The essential assessment criterion for the purposes of both stages ought to be the principle of causal responsibility.³¹ In deciding whether a branch line should be closed or how much should be offered to keep it open, the ICC should give careful scrutiny to those costs that the railroad would be caused to suffer as a result of its failure to abandon the branch line.³²

Consider first the decision whether a branch line should be closed. That decision, as already indicated, turns on the balance struck between efficiency and lost income. Despite section 1a's tilt, it is still perfectly clear that the ICC may decide, in any given proceeding, to sacrifice efficiency in order to protect lost income to keep a particular branch line open. In making such a decision, of course, the ICC would have to give proper consideration to the efficiency gains from abandonment. To give that kind of consideration, the ICC would have to understand how abandonment could yield efficiency and how those gains could be measured. Abandonment would yield efficiency by freeing resources that would otherwise be used to continue branch line service the costs of which its patrons are unwilling to pay.³³ Once freed, those resources would not remain idle long. They would be used to create some other service or even a product for which its consumers would be willing to pay. Creating that other service or product would put those

29. Ex Parte No. 274 (Sub-No. 2). *Abandonment of Railroad Lines and Discontinuance of Service* 4-5 [hereinafter cited as ICC Abandonment Regulations Report] (reprinted in Brief of Railroad Petitioners at apps. 87-88, *Chicago & North Western Transp. Co. v. United States*, 582 F.2d 1043 (7th Cir. 1978) [hereinafter cited as Brief of Railroad Petitioners]).

30. See Price & Berardino, *supra* note 27, at 133-34.

31. I. A. KAHN, *THE ECONOMICS OF REGULATION* 71 (1970) [hereinafter referred to as KAHN].

32. As a result of a failure to abandon a branch line, society may suffer costs that the railroad does not. For example, society, but not the railroad, may suffer the costs of traffic jams created when trains operating on branch lines cross highways. It would be difficult to measure these external costs. Even if they could be measured the principle of second-best might suggest that the ICC ignore them in making its decisions. And even if they could be measured and the ICC considered them, they might be balanced by external benefits.

33. That branch line patrons are unwilling to pay the costs of continued branch line service may be inferred from the fact that the railroad proposes the branch line for abandonment. If the patrons were willing to pay those costs, the railroad would have little reason to abandon.

resources to a more valuable use, as measured by willingness to pay, than would continuing branch line service. Freeing those resources, therefore, would be efficient. The gains could be measured by the difference between the payments branch line patrons would be willing to make for continued service and the costs that could be saved through abandonment. Those payments would be approximately equal to expected branch line revenues.³⁴ The costs saved would be those the railroad would be caused to suffer as a result of its failure to abandon the branch line. Thus, in deciding whether a branch line should be closed, the ICC must assess avoidable costs on the basis of causal responsibility.

Now consider the decision of how much should be offered to keep a branch line open. In analyzing that decision it would be prudent to recall that if an offer is deemed adequate, the ICC would have to postpone abandonment for a reasonable period of time, not to exceed six months, in order to give the railroad and the potential subsidizer an opportunity to negotiate a subsidy/continuation agreement. During that negotiation period, of course, the railroad would incur costs for which it would never be wholly reimbursed. Presumably, Congress decided that it was worth incurring those costs in return for the possibility that the negotiations would result in continued branch line service offered on a financially sound basis. Congress enacted its decision in section 1a. The preceding analysis suggests that the ICC should require a potential subsidizer to just compensate the railroad for the loss it would incur by continuing service for the duration of the agreement. Requiring any less or any more would be inconsistent with section 1a. If the ICC were to require any less, the offer would never be accepted by the railroad. That would mean that the costs of the negotiation period could be incurred even though there would be virtually no possibility of continued service. If the ICC were to require any more, the potential subsidizer might refrain from making an offer or end up paying the additional sum to the railroad. That could mean that negotiations which might have led to continued service would simply not take place; or, it could mean that wealth that the subsidizer, or supporting taxpayers could have used to satisfy other wants would be devoted, perhaps

34. The payments that branch line patrons would be willing to make for continued service would probably not be precisely equal to expected branch line revenues. The reason for the likely variance is that patrons might be willing to pay more than the ICC would permit the railroad to charge them. What the ICC permits the railroad to charge would limit expected branch line revenues.

inefficiently, to continued branch line service.³⁵ And what loss would the railroad incur? The loss would be identical to the efficiency gains from abandonment. It would equal the amount by which expected revenues would fall short of the costs that the railroad would be caused to suffer as a result of its failure to abandon the branch line. Thus, in deciding how much should be offered to keep a branch line open, just as in deciding whether a branch line should be closed, the ICC must assess avoidable costs on the basis of causal responsibility.

Causal responsibility cost assessment appears to be perfectly consistent with section 1a's tilt toward efficiency. And it seems to be required by section 1a's language which defines "avoidable costs" as:

all expenses which would be incurred by a carrier in providing a service which would not be incurred . . . if the line over which such service was provided were abandoned. Such expenses shall include but are not limited to all cash inflows which are foregone and all cash outflows which are incurred by such carrier as a result of . . . abandoning such service.³⁶

Unfortunately for the ICC, putting causal responsibility cost assessment to work is problematic. It is difficult to attribute a given cost to a particular service because many costs are incurred to produce more than one service³⁷ and/or counted long after a service is produced.³⁸

Section 1a does not solve these problems. It merely provides that:

foregone cash inflows and incurred outflows shall include (i) working capital and required capital expenditures, (ii) expenditures to eliminate deferred maintenance, (iii) the current cost of freight cars, locomotives, and other equipment, and (iv) the foregone tax benefits from not retiring properties from rail service and other effects of applicable Federal and State income taxes.³⁹

So, with relatively little guidance from the statute, the ICC pursued its task by promulgating regulations that further described "avoidable costs."⁴⁰ These regulations provided that avoidable costs would include:

(1) "deferred maintenance" costs necessarily incurred to rehabili-

35. The lump-sum wealth transfer would not itself engender inefficiency. Neither the subsidizer's nor the railroad's marginal revenues or marginal costs would be affected by it. Typically, however, the subsidizer is a tax-based political jurisdiction, and any levies required to pay for the subsidy might engender inefficiency by affecting the marginal revenues and marginal costs of the taxpayers subject to them.

36. 49 U.S.C. § 1a(11)(a) (1976) (current version at 49 U.S.C. § 10905(a)(1) (Supp. 1979)).

37. KAHN, *supra* note 31, at 75-83. Cf. Young, *A New Regulatory Accounting System for Railroads*, 43 I.C.C. PRAC. J. 457, 463 (1976) (in analyzing the deficiencies in the ICC's railroad cost accounting system, the author explains that most operating expenses are not classified by functions but rather by the item of property with which they are associated).

38. KAHN, *supra* note 31, at 70-75.

39. 49 U.S.C. § 10905(a)(1) (Supp. 1979).

40. 49 C.F.R. §§ 1121.40-1121.46 (1977).

tate a branch line to minimum class I safety standards, as set by the Federal Railroad Administration, or to a higher safety standard if a potential subsidizer requested a level of service which required it;⁴¹

- (2) the original cost of the locomotives and cars apportioned to the branch line on the basis of the locomotive-hours or car-miles of use and to the subsidy-continuation period on the basis of straight-line depreciation accounting;⁴² and
- (3) the return required on the investment in locomotives and cars to be used on the branch line as measured by the interest rate applicable to the most recent equipment trust certificates, conditional sales agreements or equipment lease.⁴³

Some of these regulations were challenged in *Chicago & North Western Transportation Co. v. United States*.⁴⁴

The railroads⁴⁵ in *Chicago & North Western Transportation Co.* asked the Seventh Circuit to invalidate these regulations on the ground that they were inconsistent with the section 1a definition of avoidable costs.⁴⁶ In particular, the railroads objected that in applying these regulations the ICC would, at both stages of the process, illegally ignore certain costs.⁴⁷ Those would be the costs of rehabilitating branch lines to a condition that the railroads would consider optimal; replacing the locomotives and cars to be used on the branch line; and financing capital acquisitions through the sale of equity securities. The court's analysis of these objections was generally inadequate, although its dispositions were for the most part correct or at least acceptable. Let us consider them seriatim.

Deferred Maintenance

Assessing deferred maintenance costs on the basis of causal responsibility is relatively simple. By failing to abandon a branch line, a railroad would be caused to suffer the costs of any track and roadbed rehabilitation necessary for continued service. The extent of that rehabilitation would depend in part on safety regulations and in part on demand. Federal Railroad Administration regulations prohibit trains from operating over a line that fails to meet the agency's class one

41. *See id.* § 1121.42(b).

42. *See id.* §§ 1121.42(c)(4), 1121.42(l), 1121.42(m).

43. *See id.* §§ 1121.42(c), 1121.42(l)(3).

44. 582 F.2d 1043 (7th Cir. 1978).

45. The railroad petitioners were twenty-three railroads and the American Association of Railroads. Brief of Railroad Petitioners, *supra* note 29, at attachment A.

46. 582 F.2d at 1045.

47. *See* Brief of Railroad Petitioners, *supra* note 29. The court either did not perceive or ignored the relationship between the regulations and the stage one decision.

safety standards.⁴⁸ If service were to be continued over a branch line that did not pass muster under those minimum standards, the line would have to be rehabilitated to correct for its failings. The costs of at least that rehabilitation should certainly be included in the ICC's calculation of avoidable costs—and they were. It is arguable that the costs of additional rehabilitation should also be included. A potential subsidizer may demand service of a quality that could not be rendered over a line that meets only minimum standards. The subsidizer might demand, for example, a schedule that would require trains to traverse a branch line at speeds in excess of the ten mile per hour limit on FRA-class-1 lines.⁴⁹ In that event, additional rehabilitation would have to be undertaken. The costs of that, but only that, rehabilitation should also be included in the ICC's calculation of avoidable costs⁵⁰—and they were. So, it would appear that the ICC, in promulgating its regulations for the assessment of avoidable deferred maintenance costs, performed its relatively simple job well.

Still, the railroads objected. They argued that the ICC regulations were improperly exclusive.⁵¹ The railroads perceived that track and roadbed conditions that would satisfy safety regulations, or even satisfy the demand for service, would not necessarily satisfy a railroad engineer. They wanted the ICC to include in its avoidable cost calculations the costs of rehabilitation necessary to put a branch line into optimal condition.⁵² The railroads' position was understandable, but completely unsupportable. Engineering optimality, of course, is irrelevant to causal responsibility cost assessment.

The Seventh Circuit, apparently, did not quite understand the railroads' objection or perhaps the court interpreted the objection in what it thought was a charitable light. The railroads, according to the court, were concerned about efficiency.⁵³ They anticipated that a potential subsidizer might demand service that could be rendered at the lowest total cost if the railroads undertook extensive rehabilitation.⁵⁴ Yet, they worried that the potential subsidizer would insist, despite the fact

48. 49 C.F.R. § 213.9 (1977).

49. *Id.* See 582 F.2d at 1053.

50. The costs of additional rehabilitation undertaken to satisfy the service demands of a potential subsidizer could only be included in the calculation of avoidable costs for the purpose of determining whether a subsidy continuation offer is adequate.

51. 582 F.2d at 1053-54.

52. Brief of Railroad Petitioners, *supra* note 29, at 32-39.

53. 582 F.2d at 1053-54. The railroads probably hoped that each subsidizer would be required to finance extensive repairs so that they could then attract additional customers with improved service.

54. *Id.*

that it would bear the higher cost, that the railroads undertake only limited rehabilitation and thereby incur extra operating expenses.⁵⁵ The railroads' concern was misplaced, observed the court, because the railroads would be compensated, in any event, for all their avoidable costs.⁵⁶ In a portion of the Seventh Circuit's opinion which seemed to implicitly recognize the soundness of causal responsibility assessment, the court rejected what it took to be the railroads' objection and upheld the ICC's position.⁵⁷

Capital Equipment Costs

Assessing the costs of capital equipment like locomotives and freight cars on the basis of causal responsibility is fairly complex, unlike making a similar assessment for deferred maintenance. To understand the proper methodology, one must initially grasp the general theory of attributing capital equipment costs and then see how it applies in the calculation of the avoidable costs of continued branch line service.

The general theory provides an analytical framework for deriving an answer to the question: What additional capital equipment costs, if any, must be suffered as a result of a decision to meet an increase in the demand for service? The analysis turns on whether a "short-run" or "long-run" perspective is adopted. The general theory, therefore, has two distinct parts, one corresponding to each perspective.⁵⁸

Adopting a short-run perspective, one assumes that increases in the level of service demanded will be accommodated with the capacity available from existing capital equipment. Under that assumption, the costs of the capital equipment are then the costs of using that capacity. The nature of those costs depends on the relationship between capacity and demand. On the one hand, as long as excess capacity exists, increases in the level of service demanded will inevitably lead to more intensive equipment utilization. More intensive equipment utilization will result in greater wear and tear. Greater wear and tear will impose additional costs of future repair if the equipment is likely to be repaired at all. Users whose consumption increases the demand for service are completely responsible for the additional costs of repair.⁵⁹ On the other hand, once capacity is exhausted, increases in the level of service

55. *Id.* at 1054.

56. *Id.*

57. *Id.*

58. *See generally* KAHN, *supra* note 31, at 70-75.

59. *Id.* at 71.

demand will necessarily put the enterprise in the position of having too little equipment to meet the needs of all users. Some users will have to postpone or do without service, which represents a real loss of value, an opportunity cost. The more users that postpone or do without, the greater will be the opportunity costs. Users whose consumption increases the demand for service are responsible for those opportunity costs in the same proportion that their actual use bears to total use.⁶⁰

We can now apply the short-run perspective portion of the general theory to a railroad's failure to abandon a branch line. The failure will increase the demand for rail service above the level that would prevail if the line were abandoned. To the extent that the railroad has excess capacity, it will respond to that increase by utilizing some of its locomotives and freight cars to provide branch line service. That equipment will naturally suffer more wear and tear than it otherwise would. More wear and tear will create a bigger need for future repair. Whether that need is likely to be met is not at all clear. For example, the railroad would probably not repair equipment that was unsuitable for service elsewhere on its system if the railroad did not expect that branch line operations would be continued for very long.⁶¹ Still, if the railroad is likely to undertake that repair, then the costs of that repair should be included in the avoidable costs of continued branch line services. To the extent that the railroad has exhausted capacity, however, it will be unable to utilize its locomotives and freight cars more intensively. It will have to conduct branch line operations with equipment fully utilized. As a result, some shippers will have to delay or forego rail service. Those shippers will sustain losses equal in value to the prices they would have been willing to pay had they been served promptly or at all. The losses—opportunity costs—will be imposed on deprived shippers by other shippers actually served. These opportunity costs should be included in the avoidable costs of continued branch line service in the same proportion that branch line equipment use bears to total use.

Calculated on the basis of a short-run perspective, the costs of using capacity are those of future repair and lost opportunity. Both types of costs may be properly included in the avoidable costs of continuing

60. *Id.* at n.20.

61. The implication of the railroad petitioners' argument against the ICC's deferred maintenance regulations was that some of the equipment used on the branch lines would be unsuitable for use on the main lines. See Brief of Railroad Petitioners, *supra* note 29, at 32-39. See generally KAHN, *supra* note 31, at 73.

service over many branch lines since, during the continuation period, demand will vary seasonally while the railroad's capacity will remain fixed.

We have not yet considered all the capital equipment costs that may be suffered as a result of a decision to meet increases in the demand for service. Our omission stems from the assumption that such increases would be accommodated with the capacity available from existing capital equipment. In fact, it may cause an enterprise, like a railroad, to expand capacity through the acquisition of additional capital equipment. The cost of capital equipment then becomes the cost of expanding capacity, including both investment and return on investment.⁶² We now account for those costs by adopting a long-run perspective.

An enterprise will not expand capacity in response to every increase in the demand for service. It is quite clear, for example, that expansion will not be undertaken in response to a non-repeating, temporary increase. It may not be as clear, but it is far more significant, that expansion will also not be undertaken in response to an "off-peak" increase. To illustrate, consider the likely response of a Florida electric power utility to the decisions of most of its customers to install attic fans in their homes for spring and fall cooling. Note that the utility's existing generating capacity would be designed to meet the voracious demands of homeowners who operate their air-conditioners during summer afternoons and evenings, the peak demand periods. The decisions to install attic fans would undoubtedly increase the demand for electricity. But the increase would be completely off-peak. Spring and fall demand, even inflated by attic fan cooling, would still be less than summer afternoon and evening demand. Existing generating capacity would easily handle the off-peak increase. The utility would have no reason to expand. An enterprise will expand capacity only in response to an on-peak increase in the demand for service that is likely to be sustained.

For another example, consider the response of the same utility to the unanticipated decision of several entrepreneurs to open an air-conditioned shopping mall within its franchise area. The decision to open the mall, like the decisions to install attic fans, would increase the demand for electricity. But this increase would be, in part, "on-peak". Summer afternoon and evening demand, enlarged by mall air-conditioning, might threaten to overwhelm the company's capacity. To

62. See generally KAHN, *supra* note 31, at 88-89.

avoid "brown-outs" or even "black-outs", the utility could be expected to acquire additional generating facilities. It is customer purchases during the peak periods, then, that will cause an enterprise to expand capacity.⁶³ Assuming that capacity may be used interchangeably to provide on- and off-peak service, it is peak consumption that is completely responsible for all the costs of expansion. Those are the costs of acquiring additional capital equipment and include the costs of financing the acquisition.

We can now apply the long-run perspective portion of the general theory to a railroad's failure to abandon a branch line. The failure, as previously noted, would increase the demand for rail service above the level that would prevail if the line were abandoned. We could expect the increase to be partly on-peak and partly off-peak because the railroad, if it is like most, will experience seasonal demand peaks while branch line service is continued throughout the year. The on-peak branch line service, along with all the other on-peak service, could cause the railroad to expand capacity. Assuming that capacity can be used interchangeably to provide both on- and off-peak service,⁶⁴ it would be the peak service that would be completely responsible for all the costs of expansion. Those would be the costs of future purchases or leases of additional locomotives and freight cars and would include the costs of financing those transactions. Those costs should be included in the avoidable cost of continued branch line service in the same proportion that on-peak branch line service bears to total on-peak service.

These applications of the general theory of attributing capital equipment costs on the basis of causal responsibility will serve as comparative guides in the evaluation of the ICC's regulations for assessing avoidable locomotive and freight car costs. These applications are authoritative guides because they are consistent, as previously shown, with the function and language of section 1a and its tilt toward efficiency. Consider first the ICC regulations that provide that avoidable costs would include the original cost of locomotives and cars apportioned to the branch line on the basis of locomotive-hours or car-miles of use and to the subsidy continuation period on the basis of straight-

63. *Id.* at 89. It is difficult to identify those periods that should be considered peak because they may shift over time. They may shift in response to the imposition of all capacity costs on consumption during particular periods or they may shift because of changes in living patterns and available technology. Consumption at all peak periods should bear responsibility for capacity costs, apportioned on the basis of the intensities and elasticities of demand during the various period. *Id.* at 89-94.

64. The costs of capacity used only for on-peak service must be attributed differently. *Id.* at 89, 97-98.

line depreciation accounting.⁶⁵

These “original cost” regulations are subject to two alternative interpretations. They may have constituted the ICC’s attempt to account for the greater wear and tear on locomotives and freight cars that might be caused by continued branch line service, as did the correct application of the short-run perspective part of the general theory. If so, as “cost-of-capacity-use” regulations, they were badly flawed. They were either fashioned in a completely arbitrary and capricious manner or, granting the ICC the benefit of the doubt, based on four erroneous assumptions. The first assumption may be deduced from the ICC’s failure to account for opportunity costs. Recall that such opportunity costs would be incurred if the railroad serving the line exhausted its hauling capacity. The ICC must have assumed that every railroad proposing branch line abandonments would experience constant excess capacity. The ICC thus ignored opportunity costs and accounted only for the other type of short run costs, the costs of additional future repairs. It accounted for them on the basis of straight-line depreciation accounting, a convention that reflects the idea that capital equipment loses its value in equal increments during its useful life. The second and third assumptions are implicit in the use of that convention. The ICC must have assumed that wear and tear on locomotives and freight cars occurs uniformly during their useful lives. It must have also assumed that only wear and tear, and not technological obsolescence, causes such equipment to decline in value, to depreciate. The regulations provided that the costs of additional future repairs, accounted for on the basis of straight-line depreciation, were to be considered avoidable whether or not the railroad proposing abandonment was likely to incur them. The fourth assumption may be inferred from the unconditional nature of the regulations. The ICC must have assumed that railroads always undertake repairs to remedy past wear and tear. Cost-of-capacity-use regulations based on these erroneous assumptions would tend to generate cost assessments that would vary from the principle of causal responsibility, and would be, therefore, of questionable propriety.

It is possible, alternatively, that the original cost regulations constituted the ICC’s attempt to account for the acquisition of additional locomotives and freight cars that might be caused, in part, by continued branch line service, as did the correct application of the long-run perspective part of the general theory. If so, as “cost-of-capacity-acquisition” regulations, they suffered from two inexcusable errors. One,

65. 49 C.F.R. §§ 1121.42(c)(4), 1121.42(l), 1121.42(m) (1977). See notes 40-43 *supra*.

the regulations required equipment valuation at the original cost of existing equipment rather than the expected cost of to-be-acquired equipment. Two, they reflected absolutely no consideration of coincident peak load demand. Moreover, the regulations rested on transparent *post hoc ergo propter hoc* reasoning. The reasoning appears to have been as follows: the ICC observed that branch line service would be continued during a given time period and, at the end of the same period, the railroad's accountants would account for a portion of the cost of existing locomotives and freight cars. The ICC then fallaciously concluded that continued branch line service caused the railroad to suffer that portion of the cost. Cost-of-capacity-acquisition regulations plagued by such errors and based on such illogic could not possibly generate cost assessments that would bear any perceptible relationship to the principle of causal responsibility. They would be, therefore, completely unacceptable.⁶⁶

Financing of Capital Acquisitions

Now consider the less ambiguous "rate of return" regulations. They provided that avoidable costs would include the return required on the investment in locomotives and cars to be used on the branch line as measured by the interest rates applicable to the most recent equipment trust certificates, conditional sales agreements or equipment lease agreements entered into by the railroad for the purchase or lease of such equipment.⁶⁷ The rate of return regulations, like the correct application of the long-run perspective portion of the general theory, accounted for financing the purchase or lease of additional locomotives and freight cars that might be caused by continued branch line service. The two were not identical, however, for the regulations were based on present financing costs while the application was based on future financing costs. The discrepancy, if substantial, might have caused the rate of return regulations to generate cost assessments not entirely in

66. The ICC could have attempted to justify its regulations on the ground that they were more administrable than ones consistent with the principle of causal responsibility. It could have pointed out, for example, that its regulations could have been implemented using available cost data whereas regulations consistent with the principle of causal responsibility could not. The attempted justification would not have been misplaced (assuming that control of abandonment decisions is itself defensible). If the costs had outweighed the gains of implementing economically sound regulations, the ICC would have been quite justified in refusing to adopt them. The ICC, in fact, did not offer any such justification. And since it made no inquiry into the costs and benefits of implementing economically sound regulations, one cannot know whether it should have. Had such a justification been offered, however, it might have provided valuable ammunition to those Congressmen, bureaucrats and academicians who favor pruning, if not rooting out, railroad regulation.

67. 49 C.F.R. §§ 1121.42(c)(6)(iv), 1121.43(l)(3) (1977). See notes 40-43 *supra*.

accord with the principle of causal responsibility. These regulations, then, like the original cost regulations, also could have been found to be deficient.

Thus, a reviewing court could have properly invalidated any or all of the ICC's regulations for assessing avoidable locomotive and freight car costs on the ground that they varied unjustifiably from the correct applications of the general theory and, therefore, were inconsistent with section 1a. Alternatively, it could have invalidated at least some of the regulations on grounds relating to the perspective—short-run or long-run—upon which the regulations were based. A reviewing court could have held that the ICC abused its discretion by adopting the wrong perspective or that the ICC failed to engage in reasoned decision-making by failing to adopt any perspective.

Recall that the general theory tells us how to attribute capital equipment costs using either a long-run or short-run perspective.⁶⁸ It does not tell us, however, which perspective to adopt for assessing the costs of any particular business decision. The choice of perspective ought to turn on consideration of a number of factors, including the probable impact of the decision, the time interval associated with the capital acquisition process, the durability of the equipment, the volatility of short-run costs and the predictability of long-run costs.⁶⁹ It is a choice that requires the exercise of informed judgment.

Consider, for example, this hypothetical case. A potential subsidizer wishes to have a railroad continue service over a branch line that has been certified for abandonment. The subsidizer is interested in service continuation for only one year and the ICC has determined that it will not delay abandonment for a longer period.⁷⁰ With such a short time horizon for branch line service, it might be predicted that the railroad would ignore that service in making and implementing a multi-year plan for the acquisition of long-wearing locomotives and freight cars. If it were so predicted, it would be appropriate to adopt a short-run perspective for assessing the avoidable locomotive and freight car costs of continued branch line service. Indeed, in the absence of countervailing considerations, a court could very well deem the adoption of

68. See text accompanying note 58 *supra*.

69. KAHN, *supra* note 31, at 83-89.

70. That the ICC might choose to delay abandonment for a longer period is made clear by regulations reserving the ICC's "right to reopen . . . an abandonment . . . proceeding to consider, among other things, any change in circumstance resulting from a financial assistance program which might reflect upon the merits of the abandonment . . . application." 49 C.F.R. § 1121.38(l) (1977).

a long-run perspective an abuse of discretion and strike down all regulations based on it. Cases like this hypothetical one, or others similarly calling for the adoption of a short-run perspective, could well predominate in the real world. If they did, a reviewing court could then strike down as improperly based on a long-run perspective the rate of return regulations and the original cost regulations, if it interpreted the latter as the ICC's attempt to account for the acquisition of additional locomotives and freight cars.

Unfortunately, it appears that the ICC did not exercise informed judgment in choosing a perspective. The ICC's report accompanying its regulations reveals no consideration of any of the factors that ought to have borne on its choice.⁷¹ In fact, the report reveals no consideration of the choice at all. The ICC may have simply failed to choose a perspective; it may not have exercised any judgment, informed or uninformed. This view of what the ICC did is supported by the glaring inconsistencies among the regulations, however they might be interpreted. It would be inconsistent, for example, to include in avoidable costs the present costs of financing capital acquisitions but only the past costs of acquiring it. Yet, that would have been the effect of the rate of return regulations and the original cost regulations if the latter were interpreted as an attempt to account for the acquisition of additional locomotives and freight cars. It would have been equally inconsistent, for another example, to account at all for the financing of additional capital acquisitions while failing to account for any of the costs of acquisition. Yet, that would have been the effect of the rate of return regulations and the original cost regulations if the latter were interpreted as an attempt to account for greater wear and tear on capital equipment. The ICC's failure to choose a perspective impugns the soundness of all of its regulations for assessing the avoidable locomotive and freight car costs of continued branch line service. A reviewing court could have properly struck them down as not being the product of reasoned decision-making.

The Seventh Circuit's Approach

The Seventh Circuit, the reviewing court in *Chicago & North Western Transportation Co.*, invalidated the ICC's regulations for assessing avoidable locomotive and freight car costs.⁷² In so doing, however, the Seventh Circuit did not rely on any of the proper grounds. Instead, the

71. See ICC Abandonment Regulations Report, *supra* note 29.

72. 582 F.2d at 1053.

court relied on grounds that were wholly unrelated to the economic function of section 1a. In striking down the original cost regulations, the court relied on a mechanical reading of an abstruse clause in section 1a.⁷³ The Seventh Circuit tried to bolster that reading with a strained interpretation of the testimony of one railroad-employee witness given before the Senate committee that considered the legislation which eventually became section 1a.⁷⁴

Recall that section 1a contains a rather unenlightening description of avoidable costs.⁷⁵ Section 1a provides that avoidable costs are to be assessed in accordance with the principle of causal responsibility and that such costs are to include: working capital and required capital expenditures, expenditures to eliminate deferred maintenance, *the current costs of locomotives and cars*, and certain tax benefits.⁷⁶

The Seventh Circuit relied upon the "current cost" clause in striking down the original cost regulations.⁷⁷ It is difficult to ascertain the meaning of the current cost clause because, unlike the other clauses, it refers to a measure of value rather than an item. Moreover, the clause itself is vague. It tells us to measure capital equipment costs in the period for which the assessment is made, but it does not tell us which costs of what equipment to measure. Nevertheless, the Seventh Circuit found the current cost clause not only relevant but dispositive of the issue raised. The court, with the aid of counsel,⁷⁸ incorrectly framed that issue as:

[W]hether in determining avoidable cost [in accordance with section 1a] the depreciation cost for locomotives, freight cars, and other equipment attributable to branch line service should be based on (a) the original or book cost of that equipment or (b) the cost that could be avoided if the service were terminated and the equipment used elsewhere on the railroad, i.e., the cost of purchasing new equipment.⁷⁹

As previously indicated,⁸⁰ the real issue in *Chicago & North Western Transportation Co.* was whether the ICC's regulations for assessing

73. *Id.* at 1050.

74. *Id.* at 1051.

75. See note 83 *infra* and accompanying text.

76. 49 U.S.C. § 1a(11)(a) (1976) (current version at *id.* § 10905(a)(1) (Supp. 1979)) (emphasis added).

77. 582 F.2d at 1050-53.

78. See Brief of Railroad Petitioners, *supra* note 29, at 28-32; Brief of the Respondent Interstate Commerce Commission at 16-20, *Chicago & North Western Transp. Co. v. United States*, 582 F.2d 1043 (7th Cir. 1978). The Department of Justice filed a brief but it did not address itself to the avoidable cost regulations.

79. 582 F.2d at 1050.

80. See text accompanying note 45 *supra*.

the avoidable locomotive and freight car costs of continued branch line service were consistent with the general theory of attributing capital equipment costs on the basis of causal responsibility as required by section 1a. By framing the issue incorrectly, the court both begged the question and insulated two crucial aspects of the ICC's regulations from review. The court begged the question by assuming that the capital equipment "cost that would be avoided if the service were terminated" would be the "cost of purchasing new equipment."⁸¹ That assumption would be correct only if a long-run perspective were adopted and all branch line service were "on-peak." In addition, the court insulated from review the ICC's method for attributing costs to the branch line and the use of depreciation as a measure of the costs of capacity use or capacity acquisition. It did so by implicitly accepting them as appropriate. Unfortunately, the ICC's method for branch line cost attribution would be appropriate only if a short-run perspective were adopted and constant excess capacity assumed; the use of depreciation as a capacity cost measure would never be appropriate, because it is not accurate.

Since the issue, as incorrectly framed, raised problems of the valuation of locomotives and freight cars, it appeared to the court that the current cost clause bore on its resolution.⁸² The clause, however, is ambiguous since "the current cost of capital equipment" might refer to any one of at least three valuations. First, the clause might refer to that portion of the original purchase costs of existing equipment currently allocable to the subsidy/continuation period pursuant to any of a host of standard accounting conventions. Second, it might refer to the current costs that would be incurred if existing equipment were replaced, presumably allocated in some unspecified but arbitrary manner to the branch line and to the subsidy/continuation period. Third, it might refer to that portion of the costs of future purchases of additional equipment for which branch line service during the subsidy/continuation period would be currently causally responsible. The clause has no "natural" meaning, despite the Seventh Circuit's claim to the contrary. It should have been interpreted in light of the economic function of section 1a. Then, the clause would have been read as referring to the third valuation, the cost of future purchases. It was not so read. Rather, the court read the clause as referring to the second valua-

81. 582 F.2d at 1050.

82. *Id.* at 1050-53.

tion because in ascertaining its meaning the court ignored the economic function of section 1a and relied on the statute's legislative history.

In reviewing that lengthy legislative history, the Seventh Circuit focused on the testimony of one J. H. Williams, then manager of the Bureau of Transportation Research of Southern Pacific Transportation Company, before the United States Commerce Committee.⁸³ The principal subject of Williams' testimony was the subsidy that a potential subsidizer should be required to pay in return for continued service over a branch line that a railroad had proposed for abandonment. It was Williams' position that the required subsidy should be equal to the difference between the expected branch line revenues and the "fully allocated costs" of branch line service plus a reasonable return on the economic value of the branch line. By fully allocated costs, Williams apparently meant the sum of variable costs and an arbitrarily assigned portion of fixed costs.⁸⁴ Variable costs, costs that vary with the amount of service rendered, correspond roughly to those costs for which the branch line service, if continued, would be causally responsible in the short-run. Fixed costs, costs that do not vary with the amount of service rendered, correspond roughly to those costs for which no currently offered service would be causally responsible in the short-run. Since fully allocated costs would always be greater than the costs for which branch line service, if continued, would be causally responsible, the subsidy that Williams would have required would have always been greater than that required pursuant to section 1a.

Williams suggested a statute governing abandonment that would have been consistent with his position on the required subsidy.⁸⁵ One part of that statute described how to calculate branch line revenues.⁸⁶

83. *Id.* at 1051. The United States Senate Commerce Committee was considering the legislation which eventually became section 1a. *Railroads—1975, Hearings Before the Senate Committee on Commerce, 94th Cong., 1st Sess. 795-807 (1975)* [hereinafter cited as "4-R Act" Hearings].

84. *Id.* at 796, 804-07.

85. *Id.* at 807. It is possible that Williams did not realize that the "fully distributed cost" standard was economically unsound, but it seems more likely that he was simply biased. Yet, the source of his bias is not at once clear. His superiors at Southern Pacific certainly did not use the "fully distributed cost" standard in selecting the lines they would propose for abandonment. Had they used it, they might well have selected some lines that were contributing to the company's net revenues, lines for which marginal revenues exceeded marginal costs but not fully distributed costs. Abandoning such lines would have tended to impoverish the company. So why did Williams try to persuade the Congress to enact the fully distributed cost standard into law? Perhaps the answer lies in the fact that abandonment does not occur unless a railroad proposes it. There is no danger that a railroad will be forced to abandon a line if it does not wish to do so. If it does wish to do so, however, it wants administrative scrutiny of its decision to be as lax as possible. Had Williams succeeded, then, his superiors at Southern Pacific would have been permitted wide managerial discretion in arriving at abandonment decisions.

86. *Id.* at 807.

A second part described how to calculate fully allocated costs.⁸⁷ Finally, a third part described how to calculate a reasonable return on the economic value of the branch line.⁸⁸ The third part provided that the ICC would make the calculation in the traditional manner, multiplying the value of the rate base by the appropriate rate of return. The suggested statute also provided, however, that the ICC would value the rate base in a rather untraditional manner, at its market value, not original value less depreciation.⁸⁹ The rate base would thus include, but not be limited to: the market value of land; salvage; the tax benefit from retirement; the *current cost of freight cars and locomotives*; working capital; required capital expenditures; and expenditures to eliminate deferred maintenance.⁹⁰ Valuing the rate base at its market value is a form of replacement cost valuation. This form of valuation is plagued by numerous practical problems which have been well-documented.⁹¹ Section 1a contains no directive controlling the calculation of the reasonable return on the value of the branch line.

The Congress, in enacting section 1a, apparently rejected Williams' position on the required subsidy, rejected his suggested statute, and rejected replacement cost valuation of the rate base. Congress did, however, use some language in section 1a similar to some of the language used by Williams in his suggested statute. Among the similar language was the phrase "current cost of freight cars and locomotives." In section 1a, the language was used in the context of describing avoidable costs; in Williams' suggested statute, the language was used in the context of describing the calculation of a reasonable return on the economic value of the branch line.

The Seventh Circuit seized on this similarity in language as the key to deciphering the current cost clause.⁹² The court interpreted the clause as meaning what Williams had intended it to mean. Thus, the Seventh Circuit ascribed to the clause a meaning given to it in an entirely different context by one railroad employee witness whose testimony was, in substance, completely rejected by the Congress.⁹³ The

87. *Id.*

88. *Id.*

89. *Id.*

90. *Id.*

91. See KAHN, *supra* note 31, at 109-16. See also J. BONBRIGHT, PRINCIPLES OF PUBLIC UTILITY RATES 224-37 (1961).

92. 582 F.2d at 1052.

93. In a feeble effort to support this interpretation of the "current cost" clause, the court noted that Senator Hartke, the Senator who presided at the time Williams testified, called Williams "one of the bright minds in this business." *Id.* at 1051 n.12, quoting from "4-R Act" Hearings, *supra* note 83 at 797. Senator Hartke asked Williams how the Congress could guarantee that

court, therefore, improperly read the clause as referring to the current costs that would be incurred if the existing equipment were replaced (allocated to the branch line on the basis of use and to the subsidy/continuation period on the basis of straight-line depreciation accounting). Since the ICC's original cost regulations were inconsistent with the clause as so read, the court struck them down.⁹⁴ The Seventh Circuit could have reached the identical result by testing the regulations against the economic function of section 1a. Had the court done so, its decision would have been based on a proper ground.

The court in *Chicago & North Western Transportation Co.* also struck down the ICC's rate of return regulations,⁹⁵ but the basis of its disposition is not readily apparent. The court did develop a fixed view about the return on a railroad's investment in locomotives and freight cars that should be included in avoidable costs: the return should equal the railroad's overall cost of financing capital, a weighted average of interest on debt and earnings on equity.⁹⁶ Why it developed this view is not evident from the court's opinion. The court did note the ICC's observation, made in its report accompanying the regulations, that a "railroad should receive a return on the equity in its rolling stock."⁹⁷ Receiving a return, however, is not necessarily the same as receiving a return equal to the railroad's overall cost of financing capital. Moreover, the ICC's observation, a response to the filings of the railroads who were petitioners on appeal, could hardly be considered an authoritative interpretation of section 1a.

The Seventh Circuit's view was, in fact, inconsistent with section 1a in that it ignored the limits of both the principle of causal responsibility and the language of the statute. The principle of causal responsibility limits avoidable financing costs to those made necessary by continued branch line service. The language of the statute limits avoidable financing costs to those incident to the acquisition of locomotives and freight cars. The costs of financing the acquisition of locomotives and freight cars made necessary by continued branch line service, the

railroads invest in railroad enterprises rather than other ventures. Williams quite correctly replied that, absent expropriation, the only way to guarantee reinvestment was to make sure that the return on investments in railroad enterprises was competitive with the return on investments in other ventures. Apparently not understanding a word of Williams' reply, Senator Hartke rejoined: "Well, think about that. You are one of the bright minds in this business. Maybe you can give us suggestions." "4-R Act" Hearings, *supra* note 83, at 797.

94. 582 F.2d at 1052-53.

95. *Id.* at 1054-56.

96. *Id.* at 1055 n.23.

97. *Id.* at 1055, quoting ICC Abandonment Regulations Report, *supra* note 29, at 77.

only capital financing costs lawfully considered avoidable, would likely be different than the railroad's overall cost of financing capital.

The difference would stem in part from the fact that the costs of financing different investments vary with investment risk. Two important determinants of that risk, as the ICC pointed out,⁹⁸ are the nature of the collateral that secures the investment and the length of the repayment period. Locomotives and freight cars are excellent collateral because they can be readily repossessed and resold and the repayment period for investments in such equipment is usually shorter than its anticipated life.⁹⁹ These favorable determinants make investing in locomotives and freight cars less risky, and thus less costly, than investing in other railroad capital.¹⁰⁰ The difference would also stem from the fact that continued branch line service, to the extent that it would be on-peak, would make necessary future, not present, equipment acquisitions. It would, therefore, be causally responsible for the future financing costs of those acquisitions, not the present average financing costs of all railroad capital.¹⁰¹ Since the court's view was itself inconsistent with section 1a, the court should not have struck down the ICC's rate of return regulations as inconsistent with that view. Once again, however, the court could have made the same disposition, based on a proper ground, had it evaluated the regulations in the light of the economic function of section 1a.

By making the right decisions about the ICC's avoidable cost regulations for the wrong reasons, the court in *Chicago & North Western Transportation Co.* sent signals to the ICC which could very well lead the agency, on remand, to promulgate regulations inconsistent with the function and language of section 1a. Such regulations, besides frustrating the will of Congress, would tend to promote inefficiency, much to the detriment of the general consuming public.

Regulatory Response to Failure to Reach a Subsidy/Continuation Agreement

According to section 1a, the ICC initially decides whether to au-

98. *Id.* at 76-77.

99. *Id.*

100. *Id.* at 77.

101. If the court had adopted the view that the return should equal the present costs of financing the acquisition of locomotives and freight cars, then it would have been compelled to uphold the regulations. As a measure of those present costs, the interest rate on the most recent debt instruments ordinarily used for their acquisition, the standard used by the ICC, would be far superior to the railroad's overall cost of financing capital.

thorize a proposed branch line abandonment.¹⁰² The ICC then decides whether a subsidy, if offered, is likely to compensate a railroad for the difference between the avoidable costs and expected revenues of continued branch line service and provide a reasonable return on the value of the branch line. Finally, it decides, if the subsidy offered is deemed adequate, how long to postpone issuing its certificate authorizing abandonment. The ICC may postpone issuance for up to six months in order to give the potential subsidizer and the railroad an opportunity to negotiate a continuation agreement.¹⁰³ Once the ICC makes its last decision, however, it is up to the parties to reach a subsidy/continuation agreement. If they fail to reach one in the period permitted, the ICC has no power under section 1a to do anything but make its certificate effective. Nevertheless, in the regulations setting forth its responses to such a failure, the ICC provided that it could not only make its certificate effective but that it could also reopen the abandonment proceeding, direct the carrier to continue to provide rail freight service for a rate of compensation determined by the ICC or take any other appropriate action.¹⁰⁴

These regulations were obviously inconsistent with the language of section 1a which expressly restricted the period of postponement to no more than six months.¹⁰⁵ The inconsistency was so obvious that even the ICC recognized it and tried to explain it away.¹⁰⁶ The ICC's explanation consisted of the following. Failure to reach a subsidy/continuation agreement substantially changes the circumstances upon which the decision to authorize abandonment was premised. The ICC may, pursuant to section 17(9)(g) of the Interstate Commerce Act,¹⁰⁷ reopen any proceeding if it finds "material error, new evidence, or substantially changed circumstances."¹⁰⁸ Thus, argued the ICC, although the regulations may be inconsistent with section 1a, they are consistent

102. 49 U.S.C. § 1a (1976) (current version at *id.* § 10905(b) (Supp. 1979)).

103. *Id.*

104. The ICC regulations provided, in pertinent part, to:

Reopen the underlying abandonment . . . proceeding to reevaluate the application on its merits in light of the . . . financial assistance offer; [d]irect the carrier to continue to provide rail freight service for an additional year in return for compensation to be computed by the Commission . . . in accordance with [certain standards] . . . or . . . [t]ake whatever action is appropriate to the particular situation and in conformity with section 1a of the act. Such action may include but not be limited to setting the matter for arbitration subject to the final review of the Commission.

49 C.F.R. § 1121.38(i)(2) (1977).

105. 49 U.S.C. § 1a(6)(a)(ii)(B) (1976).

106. ICC Abandonment Regulations Report, *supra* note 29, at 41-44.

107. 49 U.S.C. § 17(9)(g) (1976).

108. *Id.* (current version at 49 U.S.C. § 10327(g) (Supp. 1979)).

with section 17(9)(g).¹⁰⁹

The Seventh Circuit in *Chicago & North Western Transportation Co.* also recognized that the regulations were inconsistent with section 1a. The court highlighted that inconsistency by pointing out that section 1a, unlike the comparable section of the previously controlling Regional Rail Reorganization Act of 1973, contained no provisions prohibiting abandonment as long as a reasonable subsidy/continuation offer was outstanding.¹¹⁰ Highlighting the inconsistency did not, of course, blunt the force of the ICC's explanation of it. Unfortunately, the court responded to that explanation with a *non sequitur*. The court observed that the ICC's decision to authorize abandonment had to be made, by virtue of section 1a's two-stage process and the ICC's own regulations,¹¹¹ before the ICC considered any subsidy offer and without regard to the probability that one might be forthcoming.¹¹² From that observation, the court deduced that the failure to reach a subsidy/continuation agreement could not be a "changed circumstance" that would justify a reopening of the abandonment authorization proceeding.¹¹³

The court's deduction did not follow from its observation. A decision to authorize abandonment would be based, in part, on the ICC's finding that the losses that would be caused by an order to continue branch line service would exceed the gains engendered by it. Those losses would be the unreimbursed costs of providing the service. A subsidy, if accepted, would reduce those unreimbursed costs. If a railroad rejected a subsidy, it would be choosing, in a sense, to suffer some of those unreimbursed costs. The ICC could reasonably take the view that the unreimbursed costs that the railroad chose to suffer should not be counted among the losses that would be caused by an order to continue branch line service. If the ICC took that view, it could well find that the scaled down losses no longer exceeded the gains. Thus, a railroad's rejection of a subsidy offer could undermine the basis of the ICC's initial decision to authorize abandonment. Anything that could undermine the basis of the ICC's decision would certainly constitute a "changed circumstance."

Had the Seventh Circuit analyzed the regulations in terms of the

109. 582 F.2d at 1049.

110. *Id.*

111. 49 C.F.R. § 1121.38(h)(3) (1977) provides, in pertinent part:

The Commission shall not consider an offer of financial assistance or any resulting agreement in making its initial finding on the merits of abandonment . . . application[s].

112. 582 F.2d at 1049.

113. *Id.*

economic function of the six-month restriction, the Court could have reached the identical result without resorting to any logical fallacies. Restricting the period of postponement to six months strikes a balance between the losses and gains attributable to continuing branch line service during the postponement period. The losses would be the unreimbursed costs of the service rendered during that period and the gains would be the possibility that the negotiations conducted during that period would result in continued service offered on a financially sound basis. If the period of postponement were longer than six months, a distinct possibility under the regulations, the relationship between losses and gains would likely be altered. Altering that relationship would be inconsistent with the balance struck by the six month restriction. It is rather unlikely that the Congress intended the balance struck by section 1a to be subject to upset by the ICC's exercise of its long ago granted power to reopen proceedings. The ICC's regulations, under this analysis, were unquestionably invalid.

DISCONTINUATION OF RAIL COMMUTER SERVICE

To maximize profits for its owners, a business organization must respond efficiently to changes in the marketplace. Hence, a business organization must cease offering those services for which consumers are no longer willing to pay the costs. In that context, consider Consolidated Rail Corporation,¹¹⁴ the corporate "phoenix" fashioned by the Congress from the ashes of about a dozen bankrupt railroads that once served the Northeast and industrial Midwest. Conrail, a for-profit railroad,¹¹⁵ is supposed to earn its profit primarily by hauling freight and, secondarily, by providing some of the commuter services that its corporate predecessors provided. But Conrail has yet to do what it is supposed to do. Conrail's yearly revenues, the sum of payments made to it by shippers, passengers, and local governments that subsidized operations, have never matched its yearly operating costs and the federal government has compensated for the shortfalls.¹¹⁶ To do what it is supposed to do—earn, if not maximize, profits for its owners—Conrail must respond efficiently to changes in the transportation market. In particular, Conrail must discontinue commuter rail service for which passengers, along with local governments that subsidize operations, are no longer willing to pay the costs. Unfortunately, in *Illinois v. Consoli-*

114. Hereinafter referred to as Conrail.

115. 45 U.S.C. § 741(b) (Supp. 1979).

116. Wall Street Journal, Oct. 6, 1978, at 1, col. 6.

dated Rail Corp.,¹¹⁷ the Seventh Circuit sharply limited Conrail's ability to do just that.

Illinois v. Consolidated Rail Corp.

The case arose out of Conrail's attempt to discontinue commuter rail service between Valparaiso, Indiana, and Chicago, Illinois. Commuters in Valparaiso have long traveled by train to and from their places of work in Chicago. They had been unwilling, however, since April 1, 1976, if not before, to pay for all of the costs of the service.¹¹⁸ On that date, Conrail acquired the assets that the Penn Central Railroad¹¹⁹ had been using to render the Valparaiso-Chicago service and began to render the service itself.¹²⁰ For one-hundred and eighty days following the asset acquisition, Conrail was obligated to continue service under 45 U.S.C. § 744(e)(1).¹²¹ During that period, Conrail was compensated for the passenger revenue shortfall by the Secretary of Transportation.¹²² For about two years following the mandatory operating period, Conrail agreed to continue service pursuant to successive contracts with three Indiana transportation agencies.¹²³ During those two years, Conrail was compensated for the passenger revenue shortfall by the three agencies, all of which disbursed federal matching funds. Thus, from April 1, 1976, through September 30, 1978, Conrail continued the Penn Central's Valparaiso-Chicago commuter rail service without sustaining a loss.

117. 589 F.2d 1327 (7th Cir. 1978), *cert. denied*, 99 S. Ct. 2884 (1979).

118. Between April 1, 1976, and September 30, 1978, Conrail received subsidies to compensate it for the difference between the passenger revenues derived from and the avoidable costs associated with Valparaiso-Chicago service. Conrail has claimed, and no one has seriously disputed, that it has provided the service from October 1, 1978 at a loss. It is therefore reasonable to deduce that since April 1, 1976, Valparaiso commuters have been unwilling to pay for all of the costs they impose by traveling to and from Chicago by train.

119. Hereinafter referred to as Penn Central.

120. Section 742 gave Conrail the power to acquire rail properties and section 743 outlined the methods for valuation and conveyance. 45 U.S.C. §§ 742, 743 (1976).

121. 45 U.S.C. § 744(e)(1) (1976) requires:

Rail passenger service.—(1) The Corporation (or a profitable railroad) shall provide rail passenger service for a period of 180 days immediately following the date of conveyance (pursuant to section 743(b)(1) of this title), with respect to any rail properties over which a railroad in reorganization in the region, or a person leased, operated, or controlled by such a railroad, was providing rail passenger service immediately prior to such date of conveyance. Such service shall be provided on such properties regardless of whether or not such properties are designated in the final system plan as rail properties over which rail service is required to be operated, except with respect to properties over which such service is provided by the National Railroad Passenger Corporation.

122. 45 U.S.C. § 744(e)(5)(A) (1976).

123. The three agencies were the Northwestern Indiana Passenger Transportation authority, the Public Service Commission of Indiana, and the Northwestern Indiana Regional Transportation Authority. *Illinois v. Consolidated Rail Corp.*, No. 78 C 3768, mem. op. at 2 (N.D. Ill. Oct. 10, 1978).

In 1978, it became clear that the last subsidy/continuation contract would not be renewed or replaced. In response, Conrail announced, on August 1, 1978, that it intended to discontinue the service as of October 1, 1978, pursuant to the notice procedures under 45 U.S.C. §§ 744(a)(1) and 744(e).¹²⁴ To enjoin the discontinuance, the State of Illinois, the Illinois Commerce Commission, the City of Chicago, the Chicago-Indiana Railroad Commuter Association, and two individuals brought suit in the United States District Court for the Northern District of Illinois.¹²⁵ The plaintiffs claimed that Conrail could not discontinue the Valparaiso-Chicago service pursuant to the notice procedures of 45 U.S.C. §§ 744(a)(1) and 744(e), but only pursuant to approval by the Interstate Commerce Commission or state regulatory agencies under 49 U.S.C. § 10908.¹²⁶

Applicability of Sections 744(a)(1) and 744(e)

Section 744(a)(1) is a rather simple, relatively clear statute originally enacted as part of the Regional Rail Reorganization Act of 1973.¹²⁷ In pertinent part, section 744(a)(1) authorizes a railroad to discontinue a category of unsubsidized, unprofitable commuter rail service by notifying specified individuals and groups of its intentions and supporting data sixty days in advance.¹²⁸ The category is service rendered

124. 45 U.S.C. §§ 744(a)(1), 744(e) (Supp. 1979).

125. *Illinois v. Consolidated Rail Corp.*, No. 78 C 3768 (N.D. Ill. Oct. 10, 1978).

126. 49 U.S.C. § 10908 (1979) (a reenactment of what was, at the time the Seventh Circuit published its opinion, section 13(a) of the Interstate Commerce Act of February 4, 1887 ch. 104, 24 Stat. 379, § 13(a)(1), amended Act of Aug. 12, 1958, Pub. L. No. 85-625, § 5, 72 Stat. 571).

127. 45 U.S.C. § 701 (1976); Act of Jan. 2, 1974, Pub. L. No. 93-236, 87 Stat. 985.

128. Section 744(a)(1) provides:

Discontinuance.—(1) Except as provided in subsections (c) and (f) of this section, rail service on rail properties of a railroad in reorganization in the region, or of a person leased, operated, or controlled by such a railroad, which transfers to the Corporation or to profitable railroads operating in the region all or substantially all of its rail properties designated for such conveyance in the final system plan, and rail service on rail properties of a profitable railroad operating in the region which transfers substantially all of its rail properties to the Corporation or to other railroads pursuant to the final system plan, may be discontinued, to the extent such discontinuance is not precluded by the terms of the leases and agreements referred to in section 743(b)(2) of this title, if—

(A) the final system plan does not designate rail service to be operated over such rail properties;

(B) not sooner than 30 days following the effective date of the final system plan, the trustee or trustees of the applicable railroad in reorganization or a profitable railroad give notice in writing of intent to discontinue such service on a date certain which is not less than 60 days after the date of such notice or on the date of any conveyance ordered by the special court pursuant to section 743(b)(1) of this title, whichever is later; and

(C) the notice required by subparagraph (B) of this paragraph is sent by certified mail to the Commission; to the chief executive officer, the transportation agencies, and the government of each political subdivision of each State in which such rail properties are located; and to each shipper who has used such rail service during the previous 12 months.

45 U.S.C. § 744(a)(1) (1976).

over properties excluded from the final system plan, a document prepared by the United States Railway Association and approved, in general, by Congress.¹²⁹ Section 744(a)(1), in and of itself, was not applicable to Conrail's attempt to discontinue Valparaiso-Chicago service. The service was, as of October 1, 1978, unsubsidized and unprofitable and Conrail gave the required notice, but the properties over which the service was rendered were included in the final system plan. Section 744(a)(1) was applicable only if section 744(e) made it so.

Section 744(e) is a complex, poorly drafted statute originally enacted as part of the Railroad Revitalization and Regulatory Reform Act of 1976.¹³⁰ Section 744(e) is comprised of several interrelated paragraphs. Paragraph one of the statute mandates that Conrail render service over properties acquired from bankrupt railroads for one-hundred and eighty days following acquisition whether or not such properties are included in the final system plan.¹³¹ Paragraph two dictates the level of service that Conrail must provide during the mandatory operating period and requires that transportation authorities financially support commuter rail service during the mandatory operating period to the same extent the authorities supported it prior to acquisition. Paragraph two also makes the critical reference to section 744(a):

If a . . . [transportation authority] . . . was providing financial assistance to support the operation of rail passenger service, pursuant to a lease or agreement which was in effect immediately prior to the date of [acquisition, Conrail] . . . shall be bound by the service provisions of such lease or agreement for the duration of the 180-day mandatory operation period specified in paragraph (1) of this subsection. If . . . such an authority was providing financial assistance for the continuation of rail passenger service on rail properties immediately prior to such date of [acquisition], it shall provide the same level of financial assistance during such 180-day mandatory operation period. If no such financial assistance was being provided or if no such lease or agreement was in effect immediately prior to such date of [acquisition], with respect to any such rail properties, [Conrail] . . . shall provide the same level of rail passenger service, for the duration of the such 180-day mandatory operation period, that was provided prior to such date by the applicable railroad. If—

(A) such financial assistance is not provided;

(B) a . . . [transportation authority] has not, by the end of such 180-day mandatory operation period, offered a rail service continuation payment . . . ;

129. 45 U.S.C. § 718(d)(1) (Supp. 1979).

130. *Id.* § 801 (1976).

131. *Id.* § 744(e)(1).

(C) an applicable rail service continuation payment . . . is not paid when it is due; or

(D) a payment required under a lease or agreement . . . is not paid when it is due,

*[Conrail] . . . may (i) discontinue such rail passenger service, and (ii) with respect to rail properties not designated for inclusion in the final system plan, abandon such properties pursuant to subsections (a) and (b) of this section.*¹³²

Paragraph four directs that the railway continue to provide the service after the one-hundred and eighty day period if a transportation authority offers the railway a continuation payment, "except as otherwise provided in this subsection."¹³³ Finally, paragraph five of section 744(e) directs the Secretary of Transportation to reimburse Conrail for any otherwise unsubsidized losses it might suffer as a result of rendering service during the mandatory operating period.¹³⁴

Before it can be determined whether section 744(e) made section 744(a)(1) applicable to Conrail's attempt to discontinue Valparaiso-Chicago service, the applicability of section 744(e) itself must be established. The language of paragraph two, the only paragraph that explicitly permits Conrail to take any action to discontinue service, did not apply. It permits Conrail to take action to discontinue service under four circumstances, not one of which is the expiration of the last applicable subsidy/continuation contract. The policy underlying section 744(e), however, did apply. That policy is that the continuance of unprofitable commuter rail service should be compelled only when a compensating subsidy is available. Paragraph two effectuates that policy by permitting Conrail to take action to discontinue service when, if it did otherwise, it would face the prospect of unsubsidized losses. Paragraphs one and five effectuate that policy by compelling Conrail to continue service during a mandatory operating period while assuring it of a subsidy to compensate for any resulting losses. Language and policy appear irreconcilable, but consider paragraph four. Paragraph four may be interpreted as impliedly permitting Conrail to take action to discontinue service at the expiration of the last applicable subsidy/continuation contract as "otherwise provided in this subsection"

132. *Id.* § 744(e)(2) (emphasis added).

133. Section 744(e)(4) provides, in pertinent part:

If a . . . (transportation authority) . . . offers a rail service continuation payment . . . for the operation of rail passenger service after the 180-day mandatory operation period, . . . [Conrail] shall continue to provide such service after the end of such period, except as otherwise provided in this subsection.

45 U.S.C. § 744(e)(4) (1976).

134. *Id.* § 744(e)(5).

and that phrase may be interpreted as referring to paragraph two.¹³⁵ Paragraph four may be interpreted, in effect, to add one circumstance to the list of four in paragraph two. That interpretation would do no violence to paragraph two while effectuating the underlying policy of section 744(e). It should, therefore, be adopted. Thus, section 744(e) apparently was applicable to Conrail's attempt to discontinue Valparaiso-Chicago service.

Whether section 744(e) made section 744(a)(1) applicable then turns on the meaning of the following key clause in section 744(e):

[Conrail] . . . may (i) discontinue such rail passenger service, and (ii) with respect to rail properties not designated for inclusion in the final system plan, abandon such properties pursuant to subsections (a) and (b) of this section.¹³⁶

In that clause, Congress granted Conrail abandonment and discontinuance powers that were to be exercised according to statute. Most elements of that grant of power were not seriously disputed. Conrail clearly had the power to abandon non-final system plan properties. It could do so pursuant to section 744(b) which authorized Conrail, upon proper notice, to abandon properties over which service had been discontinued in accordance with section 744(a). Conrail also had the power to discontinue any unsubsidized, unprofitable commuter rail service that it provided during a mandatory operating period. What was disputed was whether Conrail could exercise that power to discontinue pursuant to section 744(a). The plaintiffs argued that Conrail could not do so. According to them, Conrail had to proceed under 49 U.S.C. § 10908 which made discontinuance subject to the approval of the ICC or state regulatory agencies. As the plaintiffs read the clause, "pursuant to subsections (a) and (b) of this section" modified only the grant of abandonment powers. Conrail, of course, disagreed. As Conrail read the clause, the "pursuant to" phrase modified the grant of discontinuance as well as abandonment powers. The district court adopted Conrail's reading of the clause and dismissed the suit.¹³⁷ The Seventh Circuit adopted the plaintiffs' interpretation and reversed.¹³⁸

135. The plaintiffs argued that "as otherwise provided in this subsection" referred to paragraph six which provided "[n]otwithstanding any other provision of this subsection, [Conrail] is not obligated to provide rail passenger service on rail properties if a . . . (transportation authority) contracts for such service to be provided on such properties by an operator other than [Conrail], except that [Conrail] shall, where appropriate, provide such operator with access to such properties for such purpose." 589 F.2d at 1331, *citing* 45 U.S.C. § 744(e)(6) (1976).

136. 45 U.S.C. § 744(e)(2) (1976).

137. No. 78 C 3768 (N.D. Ill. Oct. 10, 1978).

138. 589 F.2d at 1334.

The Seventh Circuit's Approach

In support of its adoption of the plaintiff's reading of the clause, the Seventh Circuit contended that that reading was consistent with the "Rule of the Last Antecedent,"¹³⁹ the reenactment of sections 744(a) and 744(b),¹⁴⁰ the final system plan,¹⁴¹ and the legislative history of the Railroad Revitalization and Regulation Reform Act of 1976.¹⁴² The "Rule of the Last Antecedent" is rooted not in law but in syntax. If a prepositional phrase is supposed to modify more than one verb or noun in a sentence, it is syntactically preferable that the phrase precede all of them. Such ordering eliminates ambiguity.¹⁴³ The "rule" is really a presumption that, in drafting statutes, Congress never fails to use preferred syntax. It teaches that a prepositional phrase which follows more than one verb (or noun) in a statute modifies only the last. Thus, the plaintiffs' reading of the key clause was unquestionably consistent with the "rule." That was no reason, however, for the court to adopt it. The key clause, considered out of its legislative context, may be read as it was by the plaintiffs or as it was by Conrail. That ambiguity should not have been resolved on the basis of a transparently arrogant presumption. Judges are not supposed to be stern schoolmasters who administer grammar lessons to their errant student congressmen. Moreover, the presumption, as the court admitted,¹⁴⁴ was certainly rebuttable.¹⁴⁵ The ambiguity should have been resolved on the basis of the legislative context of the key clause. To its credit, that is what the court tried, albeit erringly, to do, except for its flirtation with the "Rule of Last Antecedent."

One part of the key clause's legislative context was the reenactment, in the Railroad Revitalization and Regulatory Reform Act, of sections 744(a) and 744(b).¹⁴⁶ A reading of the key clause that would be consistent with that reenactment would have to give full effect to both the clause and sections 744(a) and 744(b). It would be rather diffi-

139. *Id.* at 1332. For a discussion of the Rule of Last Antecedent, see *United States v. Pritchett*, 470 F.2d 455, 459 (D.C. Cir. 1972).

140. 589 F.2d at 1331. See 45 U.S.C. § 744(a), (b) (1976).

141. 589 F.2d at 1331.

142. *Id.*

143. This case, for example, would never have arisen had Congress drafted the key clause as follows: "Conrail may, pursuant to subsections (a) and (b) of this section, (i) discontinue such rail passenger service and (ii) with respect to rail properties not designated for inclusion in the final system plan, abandon such properties."

144. 589 F.2d at 1332.

145. K. LLEWELLYN, *THE COMMON LAW TRADITION* 526-27 (1960).

146. Railroad Revitalization and Regulatory Reform Act of 1976, Act of Feb. 5, 1976, Pub. L. No. 94-210 § 804, 90 Stat. 31, 133-34.

cult to give such a reading to the key clause because it is impossible to give effect to both an amendment and the statutes that the amendment changed. The key clause was part of an amendment to the statutes then governing Conrail's discontinuance and abandonment powers and sections 744(a) and 744(b) were those very statutes. The plaintiffs were unable to do the impossible. Their reading of the key clause, contrary to the court's contention, was inconsistent with the reenactment. When Conrail's powers under sections 744(a) and 744(b) are compared with Conrail's powers under the key clause as the plaintiffs read it, it becomes evident that, at best, the plaintiffs' reading rendered the key clause mere surplusage, and, at worst, it worked a repeal of section 744(a).

Under section 744(b), Conrail could, upon proper notice, abandon non-final system plan properties over which service had been discontinued in accordance with section 744(a).¹⁴⁷ The key clause, as plaintiffs read it, permitted Conrail to abandon non-final system plan properties "pursuant to subsections (a) and (b) of this subsection," and so made no change in Conrail's abandonment powers.¹⁴⁸ Under section 744(a), Conrail could, upon proper notice, discontinue service over non-final system plan properties.¹⁴⁹ The key clause, as plaintiffs read it, did not permit Conrail to discontinue service "pursuant to subsections (a) and (b) of this subsection," and so, the plaintiffs insisted, made no change in Conrail's discontinuance powers.¹⁵⁰ If what the plaintiffs insisted on had been correct, then the amendment of which the key clause was a part would have done no amending; the key clause would have been mere surplusage. It appears, however, that the plaintiffs were mistaken. The plaintiffs overlooked the fact that in the key clause there was no distinction made between discontinuing service over final system plan and non-final system plan properties. Actually, then, the clause, as the plaintiffs read it, did not permit Conrail to discontinue any service whatsoever. In effect, the clause repealed section 744(a).

A second part of the key clause's legislative context was the final system plan which Congress approved in the Railroad Revitalization and Regulatory Reform Act. As pertinent, the final service plan provided:

Services Never Covered by Leases or Contracts and Operated Over
Lines to be Acquired by Conrail

147. 45 U.S.C. § 744(b) (1976).

148. 589 F.2d at 1331. See 45 U.S.C. § 744(e)(2) (1976).

149. *Id.* § 744(a).

150. 589 F.2d at 1330-31.

The services will be continued on the day of conveyance. USRA recommends that ConRail seek a satisfactory subsidy arrangement for provisions of these services. If such agreements have not been executed by the time of conveyance, USRA recommends that ConRail post these services for discontinuance. Approval for such discontinuances must be obtained from the proper regulatory authorities.¹⁵¹

The court was obviously correct in contending that the plaintiffs' reading of the key clause was consistent with the final system plan. Since Congress approved the final system plan, that consistency appeared to provide strong support for the court's adoption of the plaintiffs' reading. That appearance was deceiving. The final system plan was prepared before the Railroad Revitalization and Regulatory Reform Act was passed. Unsurprisingly, it accurately reflected the law that controlled at the time of its preparation.¹⁵² The act, however, significantly amended the prior law. It is unlikely that Congress has ever intended that amendments be interpreted in conformity with the statutes the amendment changed. It is thus unlikely, despite Congress' approval of the final system plan, that Congress wanted the act interpreted in conformity with the prior law or the final system plan which accurately reflected it.

Moreover, Congress' approval of the final system plan was based on a projection of Conrail's profitability which was, in turn, based on the assumption that Conrail would obtain full compensation for its passenger service.¹⁵³ That assumption would be undermined if Conrail could not summarily discontinue all unsubsidized, unprofitable commuter rail service. Yet, as the plaintiffs read the key clause, Conrail could not. It would be perverse indeed to use the approval of the final system plan to support a reading which would undermine the assumption upon which that approval was based.

A third part of the key clause's legislative context was the legislative history of the Railroad Revitalization and Regulatory Reform Act. According to the Seventh Circuit, that history showed that the "motivation for the . . . Act was to provide for the continuation of certain rail passenger lines . . ." ¹⁵⁴ Continuation would, of course, be promoted by a restrictive reading of those clauses in the act which grant discontinuance and abandonment powers to private railroads like Conrail.

151. *Id.* at 1333.

152. The applicable law prior to the Railroad Revitalization and Regulatory Reform Act was the Regional Rail Reorganization Act of 1973, 45 U.S.C. § 701 (1976).

153. S. REP. NO. 499, 94th Cong. 2d Sess. 31, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 14, 45; H.R. REP. NO. 725, 94th Cong. 2d Sess. 86.

154. 589 F.2d at 1331.

The plaintiffs' reading of the key clause was certainly more restrictive than Conrail's. Thus, it was logical for the court to conclude that the plaintiffs' reading was consistent with the legislative history of the act.

The court's logic was unassailable, but its premise was completely off-base. The legislative history of the act shows that Congress wished to lessen the burden on railroads, in general, and Conrail, in particular, of providing unsubsidized, unprofitable service. Congress' wish is evidenced in the Senate conference report that accompanied the bill that eventually became the Railroad Revitalization and Regulatory Reform Act.¹⁵⁵ The Senate conference report states:

The bill makes clear the obligation of ConRail and other carriers, as determined by the ICC, to provide rail service on lines where an assistance payment is offered The bill provides that ConRail must continue service being provided on the date of [acquisition] for 180 days during which time it will be reimbursed for any losses incurred for the provision of that service ConRail is obligated to continue to provide such service after the initial 180 day period if the appropriate State or commuter authority offers a service assistance payment.¹⁵⁶

The unmistakable import of the Senate conference report is that Congress wished that Conrail be permitted to discontinue all unsubsidized, unprofitable commuter rail service. The motivation for the Railroad Revitalization and Regulatory Reform Act, then, was clearly not "to provide for the continuation of certain rail passenger lines."¹⁵⁷

Had the Seventh Circuit given proper consideration to the reenactment of sections 744(a) and 744(b), the final system plan and the legislative history of the act, it would not have resolved the ambiguity in the key clause in the manner urged by the plaintiffs. Had the court given any consideration to the most important part of the key clause's legislative context, the economic function of the act, it surely would have resolved the ambiguity in the manner urged by Conrail. The Railroad Revitalization and Regulatory Reform Act seems well designed to promote efficiency in railroad operations. With respect to ratemaking, for example, it establishes the variable cost of a service as the presumptive

155. S. CONF. REP. NO. 595, 94th Cong. 2d Sess. 131, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 148.

156. S. CONF. REP. NO. 595, 94th Cong. 2d Sess. 143-44, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 158.

157. Had the court considered the historical trend in the abandonment and discontinuance powers permitted railroads under the applicable statutes, it might have given the legislative history of the 4-R Act more careful scrutiny. The trend has been in the direction of expansion. *Compare* Act of Feb. 28, 1920, ch. 91, § 402, 41 Stat. 477 *and* Act of Aug. 12, 1958, Pub. L. No. 85-625, § 5, 72 Stat. 571 *with* Act of Jan. 2, 1974, Pub. L. No. 93-236 § 304, 87 Stat. 1008.

rate floor;¹⁵⁸ permits competition in the transportation market, where there is any, to set the rate ceiling;¹⁵⁹ and encourages peak-load pricing.¹⁶⁰ With respect to the discontinuance and abandonment of unprofitable intercity passenger service and properties, the act grants far more decision-making leeway to management than did the statutes it superceded.¹⁶¹ Plaintiffs' reading of the key clause was at odds with the economic function of the act.¹⁶² Under that reading, Conrail could be compelled to provide commuter rail service for which passengers and local governments were unwilling to pay the costs¹⁶³ and to cross-subsidize that service with revenues derived from its freight shippers. Such a result would be very inefficient. Conrail's reading of the key clause was in harmony with the economic function of the act and thus the Seventh Circuit should have adopted it.

ENTRY INTO TRUCKING MARKETS

Entry into most markets is relatively unrestricted. Generally, any entrepreneur who wishes to compete is free to do so. It is that freedom that poses a constant threat to the financial well-being of established firms. These firms stand to lose a portion of their income to new entrants if they should fail to produce what their customers demand or if they should charge prices in excess of the long-run marginal production costs that a well-managed firm using the best available technology

158. 49 U.S.C. § 10701(2)(A) (1979).

159. *Id.* § 10709.

160. *Id.* § 10727.

161. *Id.* §§ 10903-10905. Compare Act of Feb. 4, 1887, ch. 104, 24 Stat. 379 § 1a; added Feb. 5, 1976, Pub. L. No. 94-210, § 802, 809(c), 90 Stat. 127-30, 146.

162. Plaintiffs' reading was also at odds with the Rail Service Continuation Assistance program of section 805 of the Railroad Revitalization and Regulatory Reform Act which was designed to encourage the making of subsidy/continuation contracts by providing federal funds to those local governments making them. 45 U.S.C. § 805 (1976). Under plaintiffs' reading, Conrail would be permitted to summarily discontinue service if no subsidy/continuation contract were made, but would not be permitted to do the same if a contract were made but not renewed or replaced. That anomaly would create powerful disincentives to the making of subsidy/continuation contracts.

163. The court may have thought that under the key clause, as read by the plaintiffs, Conrail could not be so compelled. That seems to be the implication of (1) its observation that, despite its adoption of the plaintiffs' reading, Conrail would still be able to take action to discontinue commuter rail service expeditiously pursuant to 49 U.S.C. § 10908 (1979), 589 F.2d at 1334; and (2) its suggestion that under 49 U.S.C. § 10908, the ICC might be obligated to permit Conrail to discontinue any unsubsidized, unprofitable commuter rail service. 589 F.2d at 1332. If that is what the court thought, it was patently mistaken. If Conrail must proceed under 49 U.S.C. § 10908, it will, in all likelihood, be compelled to provide unsubsidized, unprofitable commuter rail service while it litigates its proposed discontinuances before the ICC and the United States courts of appeals; and it will have no assurance of prevailing in that litigation. In adopting the plaintiffs' reading of the key clause, the court was not merely relegating Conrail to alternative procedures but rather to the regulations and mercy of the ICC under which its corporate predecessors went bankrupt.

would incur. Of course, that threat tends to induce improvements in the variety of goods and services produced and also tends to check prices. It puts pressure on complacent or inept managers to respond to developments in their markets. It reduces the chances of successful economic collusion of the tacit or even overt variety. Hence, what is a threat to established firms is a boon to the consuming public. In our economy, in short, unrestricted entry is one of the principal spurs to efficiency in production and pricing, and, thus, to optimal allocation of our scarce productive resources.

Nevertheless, entry into some markets is restricted. Entry into most interstate trucking markets is restricted by the Motor Carrier Act of 1935,¹⁶⁴ a statute that reflects the protectionist mentality of the Great Depression.¹⁶⁵ Generally, under that statute, an entrepreneur who wishes to offer interstate trucking services must apply for a certificate¹⁶⁶ or permit¹⁶⁷ from the ICC. The applicant can obtain one only by persuading the ICC that he is "fit, willing, and able" to provide the services he wishes to offer¹⁶⁸ and that those services are "required by"¹⁶⁹ or "consistent with"¹⁷⁰ the "present or future public convenience and necessity."¹⁷¹ The ICC, of course, need not approve the application and, if it does not, the entrepreneur may not compete. It is thus clear that the ICC may, under the Motor Carrier Act of 1935,¹⁷² compromise the efficiency that would be spurred by new entry; it may do so in order to protect the income of established firms from competitive erosion.

The statute authorizes the ICC, in passing on applications for certificates or permits, to compromise but not to utterly disregard the efficiency that would be spurred by new entry. If the ICC disregarded that efficiency, entry into interstate trucking markets would be foreclosed, not merely restricted, and the consuming public would be deprived of a great boon. It does not appear that that is the economic function of the Motor Carrier Act of 1935. Moreover, foreclosing entry would be inconsistent with the decisions of the United States Supreme Court holding that established trucking firms have no right to be free from the

164. Act of Aug. 9, 1935, ch. 498, § 201, 49 Stat. 543. Certain markets not here relevant do not come within the act's reach.

165. See Jones, *Antitrust & Specific Economic Regulation: An Introduction to Comparative Analysis*, 19 A.B.A. ANTITRUST SECTION 261, 279-99 (1961).

166. 49 U.S.C. § 10922 (1979) (common carriers must have a certificate).

167. *Id.* § 10923 (contract carriers must have a permit).

168. *Id.* §§ 10922-10923.

169. *Id.* § 10922.

170. *Id.* § 10923.

171. *Id.* §§ 10922-10923.

172. 49 U.S.C. § 305 (1976).

threat of new competition.¹⁷³ In addition, such action would be inconsistent with the National Transportation Policy¹⁷⁴ which requires that trucking be regulated so as to “promote . . . adequate, economical, and efficient transportation.”¹⁷⁵ Yet, the ICC utterly disregarded the efficiency that would be spurred by new entry when it denied the application of Niedert Motor Carrier, Inc., for a certificate to transport general commodities¹⁷⁶ between Chicago and two Indiana counties in the Chicago commercial district.¹⁷⁷ In *Niedert Motor Service, Inc. v. United States*,¹⁷⁸ the Seventh Circuit reversed the denial and remanded the application, but the court failed to clearly articulate the efficiency rationale underlying its decision. The court’s failure to do so may invite the ICC to repeat its error, much to the detriment of those who ship by truck and all of us who purchase goods that are so shipped.

Niedert Motor Service, Inc. v. United States

Niedert Motor Service, Inc.¹⁷⁹ has been an intrastate motor carrier since 1925. Its principal area of operation has been that portion of Illinois within fifty miles of its terminal in Des Plaines, Illinois, a Chicago suburb.¹⁸⁰ Niedert has been authorized by the Illinois Commerce Commission to transport general commodities¹⁸¹ to all points in its principal area of operation and, when serving shippers located in that area, to all points in Illinois.¹⁸² Niedert has also been permitted to serve other points, including those out of state, by interlining with suit-

173. See *Bowman Transp., Inc. v. Arkansas-Best Freight Sys., Inc.*, 419 U.S. 281, 298 (1974); *United States v. Dixie Highway Express, Inc.*, 389 U.S. 409, 411 (1967).

174. 49 U.S.C. § 10101 (1979) (originally enacted as Act of Sept. 18, 1940, ch. 722 § 1, 54 Stat. 899).

175. 49 U.S.C. § 10101(a)(2) (1979).

176. Niedert wished to carry “general commodities, except classes A and B explosives, household goods as defined by the Commission, commodities in bulk, and those requiring special equipment.” *Niedert Motor Serv., Inc.*, 125 M.C.C. 209, 210 (1976).

177. *Id.* The two counties were Lake County and Porter County, both located in northwestern Indiana.

178. 583 F.2d 954 (7th Cir. 1978).

179. Hereinafter referred to as Niedert.

180. The terminal covered 24,000 square feet. 583 F.2d at 956. It had dock space for one hundred trailers. *Id.* at 960.

181. Niedert was authorized to transport what the Illinois Commerce Commission called general freight and household goods. *Id.* at 956. Apparently, there was no real difference between those items and the items that Niedert wished to transport to the two Indiana counties. In any event, Niedert did not apply for authority to transport items interstate that it was not already transporting intrastate.

182. According to the court, Niedert had been authorized to transport “[g]eneral freight and household goods within a fifty-mile (50) radius of 1300 Oakwood Avenue, Des Plaines, Illinois, and to transport such property to or from any point outside of such authorized area of operation for a shipper or shippers within such area.” 583 F.2d at 956.

able carriers.¹⁸³

For many years, Niedert served two Indiana counties in the Chicago commercial district by interlining with other carriers. By the beginning of 1973, however, it could no longer continue to do so. Niedert found itself unable to negotiate an interlining agreement under which it could recoup its costs.¹⁸⁴ Therefore, Niedert applied to the ICC for a certificate to replace the interlined with its own direct service.¹⁸⁵

During the administrative hearing at which Niedert's application was considered,¹⁸⁶ Niedert showed that the operations at its terminal, a vital element in the service it wished to offer, were extraordinarily efficient.¹⁸⁷ At its terminal, Niedert would typically receive from a shipper a number of packages bound for various places, segregate them according to where they were bound, consolidate them with packages received from other shippers bound for the same place, and then deliver them to their destinations or the appropriate interlining carriers. Niedert would do all this in no more than twenty-four hours and it would do so for about one million pounds of freight every working day. On the basis of this evidence, Niedert argued that the service it wished to offer was "required by the present or future public convenience and necessity." The ICC was not persuaded. It dismissed Niedert's evidence as irrelevant on the ground that Niedert's terminal operations were not transportation services.¹⁸⁸ Since Niedert had thus failed to meet its burden of persuasion, the ICC denied its application for a certificate.¹⁸⁹ Reversing and remanding, the Seventh Circuit held that the ICC had made three errors in arriving at its decision.¹⁹⁰ Analysis reveals, how-

183. See 49 U.S.C. § 10931 (1979). Interlining is the sequential handling of a given shipment by two or more carriers.

184. That was the finding of the administrative law judge and the ICC adopted it. 125 M.C.C. at 211, 212.

185. 583 F.2d at 957. See 49 U.S.C. § 10928 (1979).

186. The application was originally assigned to an employee of the Illinois Commerce Commission. Evidence was presented to him but he resigned before rendering a decision. An administrative law judge then reviewed the record and issued his decision. 583 F.2d at 957.

187. The fact that the operations at Niedert's terminal were extraordinarily efficient was undisputed. Even the ICC admitted, "it is conceded that certain aspects of applicant's service . . . cannot be matched by existing carriers . . ." 125 M.C.C. at 218.

188. *Id.*

189. It could be argued that the ICC denied Niedert's application simply because it found existing service adequate. The ICC did state, "we find that there is no public need for extension of applicant's service from the Chicago area into Lake and Porter Counties which cannot be met as well by existing carriers." *Id.* at 219. If that is what the ICC did then it was clearly in error. *Schaffer Transp. Co. v. United States*, 355 U.S. 83, 90-91 (1957); *P.C. White Truck Line, Inc. v. ICC*, 551 F.2d 1326, 1328 (D.C. Cir. 1977); *Trans-American Van Serv., Inc. v. United States*, 421 F. Supp. 308, 320-21 (N.D. Tex. 1976); *Nashua Motor Express, Inc. v. United States*, 230 F. Supp. 646, 653 (D.N.H. 1964).

190. 583 F.2d at 959-63.

ever, that those errors were really one and the same.

The Seventh Circuit's Approach

The first error of which the court complained was the ICC's dismissal of Niedert's evidence on the ground that Niedert's terminal operations were not transportation services. According to the court, that constituted an unexplained and unlawful departure from the principle underlying past ICC cases.¹⁹¹ The court found four ICC cases, in which the ICC passed on applications for new operating authority, particularly instructive.¹⁹² In each of the cases, the ICC explicitly classified particular services as transportational or non-transportational.

In *Kenosha Auto Transport Corp.*,¹⁹³ the ICC denied an application, classifying as non-transportational the storing of imported cars at the Port of Baltimore while they awaited shipment inland at unspecified future dates.¹⁹⁴ The ICC approved an application in *Griffin Mobile Home Transporting Co.*,¹⁹⁵ classifying as transportational the services required to make mobile home trailers usable after delivery to their owners.¹⁹⁶ The services proposed by *Griffin* included repairing minor damage, connecting utilities, and assembling "expando" models.¹⁹⁷ In *W.S. Hatch Co.*,¹⁹⁸ the ICC approved an application, classifying as transportational the spreading of asphalt sealer with the truck in which the sealer was hauled.¹⁹⁹ Finally, in *Tennessee Transport, Inc.*,²⁰⁰ the ICC granted an application, classifying as transportational, services required to ready houseboats for cruising.²⁰¹ The services included remounting flying bridges, catwalks, radio antennae and other items dismounted for transit, launching and test driving the boats, and instructing customers in the handling of the boats.²⁰² The Seventh Circuit declared that Niedert's terminal operations were much more

191. *Id.* at 960.

192. *Tennessee Transp., Inc.*, 124 M.C.C. 811 (1976); *W.S. Hatch Co.*, 108 M.C.C. 853 (1969); *Griffin Mobile Home Transp. Co.*, 103 M.C.C. 482 (1966), *aff'd sub nom.*, *National Trailer Convoy, Inc. v. United States*, 394 U.S. 849 (1969); *Kenosha Auto Transp. Corp.*, 83 M.C.C. 527 (1960).

193. 83 M.C.C. 527 (1960).

194. *Id.* at 536-37.

195. 103 M.C.C. 482 (1966), *aff'd sub nom.*, *National Trailer Convoy, Inc. v. United States*, 394 U.S. 849 (1969).

196. 103 M.C.C. at 500-01.

197. *Id.* at 491.

198. 108 M.C.C. 853 (1969).

199. *Id.* at 860-61.

200. 124 M.C.C. 811 (1976).

201. *Id.* at 815.

202. *Id.* at 814.

analogous to the services proposed in *Griffin*, *Hatch*, and *Tennessee* than to the services proposed in *Kenosha*. The court buttressed its declaration with a fifth ICC decision, *Jerry Lipps, Inc.*,²⁰³ in which the ICC denied an application because, *inter alia*, the applicant did not own terminal facilities needed to provide effective service.²⁰⁴ The Seventh Circuit, however, did not elucidate the principle underlying these ICC decisions or apply it to Niedert's terminal operations.

It is not difficult to deduce the principle underlying the ICC decisions, although the ICC did not articulate one. In the four ICC cases the Seventh Circuit found most instructive, the applicants all wished to offer one or more services in addition to basic transportation. Presumably, the applicants wished to do so because their potential customers had an unfulfilled need for both. It was clear that some of those additional services could be performed most efficiently by whichever carrier provided the customers with basic transportation.²⁰⁵ For example, in *W.S. Hatch Co.*, there could have been little doubt that spreading asphalt sealer with the truck in which it was transported would be more efficient than transferring the sealer to another truck and spreading it with that one.²⁰⁶ The ICC apparently perceived that it was obligated to consider such additional services in passing on each application and so it classified them as transportational.²⁰⁷ This is the principle underlying these ICC cases and so the ICC's approach was correct. Had the ICC failed to consider these additional services, classifying them as non-transportational, it would have unlawfully disregarded the efficiency that a new entrant might introduce with its own operations and induce in that of its competitors' operations. Unfortunately, that is pre-

203. 105 M.C.C. 811 (1967).

204. *Id.* at 819-21.

205. In *Griffin Mobile Home Transp. Co.*, the ICC observed that it was "not economically practicable for someone other than the carrier to render these special services apart from the line-haul transportation." 103 M.C.C. at 499. The ICC also observed that assembling the "expando" models was:

necessary to the effectuation of the matter in chief, . . . because otherwise the supporting shippers are required to send one of their own employees to the delivery site to provide such service before acceptance is given by the consignee. In such event, the house trailers would simply not be tendered to a for-hire carrier because of the prohibitive cost.

Id. at 500. In *Tennessee Transp. Inc.*, the ICC found that "[i]t would be economically unfeasible for shippers to consign boats to protestants for transport and also send an employee to the delivery site to perform the setup services." 124 M.C.C. at 814. *Kenosha Auto Transport Corp.*, the only one of the four cases in which the ICC classified a service as non-transportational, is not inconsistent with the other three. It seems rather unlikely that *Kenosha*, the transporting firm, could have performed the service of storing autos indefinitely more efficiently than any other firm.

206. In *W.S. Hatch Co.*, the ICC noted that "[i]t is clear on this record that spreading the sealer on the surface is the most feasible means of accomplishing the delivery of this commodity." 108 M.C.C. at 861.

207. *Id.* at 861-62.

cisely what the ICC did when it denied Niedert's application for a certificate. Thus, in dismissing Niedert's evidence as irrelevant on the ground that Niedert's terminal operations were non-transportational, the ICC not only departed, without explanation, from the principle underlying past ICC cases, but more importantly, shirked its duty to consider the efficiency which would have been spurred by Niedert's entry into the market.

The second error of which the court complained was the ICC's failure to consider the inherent advantages of the service which Niedert wished to offer.²⁰⁸ The court found that this violated the teaching of the United States Supreme Court in *Schaffer Transportation Co. v. United States*.²⁰⁹ The genesis of *Schaffer* was a request for operating authority to provide motor carrier service in competition with a railroad. The ICC refused the request. In so doing, the ICC failed to consider the inherent advantages of truck over train transportation. The United States Supreme Court held that such a failure contravened the section of the National Transportation Policy which requires the ICC to regulate the various modes of transportation subject to its jurisdiction so as to promote the inherent advantages of each.²¹⁰ That section is inapplicable to requests, like Niedert's, for operating authority to provide motor carrier service in competition with other motor carriers.²¹¹ But the teaching of *Schaffer* is applicable.²¹² The inherent advantages of one mode of transportation over another must be the ability of a carrier utilizing that mode to incur less costs in the performance of a particular service than a carrier utilizing the other mode.²¹³ It is precisely that sort of ability that would enable a new entrant to offer more efficient service and force its competitors to do the same. In essence, the United States Supreme Court took the ICC to task in *Schaffer* for failing to consider that efficiency. Thus, the teaching of *Schaffer* is that the ICC must, in passing on requests for operating authority, consider the efficiency which would be spurred by new entry. In refusing Niedert's request, the ICC certainly violated that teaching, thereby

208. 583 F.2d at 962.

209. 355 U.S. 83 (1957).

210. *Id.* at 89. See 49 U.S.C. § 10101(a)(1) (1979).

211. See *id.* See also 583 F.2d at 962.

212. See *Trans-American Van Serv., Inc. v. United States*, 421 F. Supp. 308, 326 (N.D. Tex. 1976); *Vincent Montone Transp., Inc. v. United States*, 231 F. Supp. 484, 488 (M.D. Pa. 1964).

213. See KAHN, *supra* note 31, at 160-66. Admittedly, the court in *Schaffer* held that in passing on applications to provide service, the ICC was obligated to compare only the "inherent advantages" of different transportation modes, not the advantages of different transportation firms. It could be argued then that the decision does not teach that the ICC must consider the relative efficiencies of firms employing the same mode.

committing the same error that it made when it dismissed Niedert's evidence as irrelevant.

The third, and final, error of which the court complained was the ICC's failure to consider the benefits of increased competition.²¹⁴ The district court found this to be in direct violation of the Seventh Circuit's own decision in *Sawyer Transport, Inc. v. United States*.²¹⁵ It is difficult to know what those benefits could be other than the efficiency that would be spurred by new entry. It appears then that in failing to consider those benefits, the ICC committed the same error it committed in failing to consider inherent advantages and in dismissing Niedert's evidence as irrelevant.

The Seventh Circuit in *Niedert Motor Service* failed to clearly explain its decision in terms of the economic function of the controlling statutes. As a result, the court held that the ICC had made three errors when it had made only one. It could be argued, of course, that that holding will insure three times over that the ICC, in passing on future applications for certificates or permits, will always consider the efficiencies that might be spurred by new entry. I think not. The Seventh Circuit's holding focuses concern on metaphysical questions such as: What is "transportation"? What advantages are "inherent"? How can the benefits of would-be competition be demonstrated? The ICC may, given its protectionist bent, develop answers to those questions which will lead it to make the same error that it made in this case. Repetition of the error could only be harmful to the consuming public. The court's decision, then, may be questioned not only on jurisprudential grounds but on quite practical ones as well.

CONTROLLING THE REVENUES AND EXPENDITURES OF PUBLIC UTILITIES

Natural Gas Pipeline Co. v. Federal Energy Regulatory Commission

In mid-1974, Natural Gas Pipeline Company of America²¹⁶ loaned \$6.7 million, interest-free, to two firms engaged in the business of producing natural gas. The funds were earmarked for exploratory drilling and well development on particular leaseholds, and they were so expended over the course of about two years. In return for the loans,

214. 583 F.2d at 963.

215. 565 F.2d 474 (7th Cir. 1977). In *Sawyer Transport*, the court relied heavily on *Bowman Transp., Inc. v. Arkansas-Best Freight Sys.*, 419 U.S. 281 (1974), and particularly, *P.C. White Truck Line, Inc. v. ICC*, 551 F.2d 1326 (D.C. Cir. 1977).

216. Hereinafter referred to as *Natural*.

Natural obtained only the right to purchase any gas that the firms might produce from those leaseholds. Although the loans were interest-free, they were hardly eleemosynary. Natural's management expected that the Federal Energy Regulatory Commission,²¹⁷ pursuant to the advance payment program,²¹⁸ would permit it to raise its rates in order to recoup from its customers at least the costs of financing the loans. Accordingly, Natural filed a request with the Federal Energy Regulatory Commission²¹⁹ for permission to raise its rates effective September 1, 1974.

The advanced payment program was one of several FERC initiatives calculated to ameliorate the natural gas "shortage,"²²⁰ the disequilibrium in supply and demand that the FERC caused in the first place by holding the wellhead rates for natural gas below market clearing levels.²²¹ The program was based on the theory that the supply of natural gas would likely increase if producers could obtain lower cost exploration and development capital.²²² It was designed to put an incentive created by traditional rate regulation to use in inducing pipelines to provide that capital.

Traditionally, a regulatory authority attempts to set rates so as to

217. Pursuant to the provisions of the Department of Energy Organization Act, Pub. L. No. 95-91, 91 Stat. 565, 42 U.S.C. § 7101 (Aug. 4, 1977), and Executive Order No. 12,009, 42 Fed. Reg. 46,267 (Sept. 13, 1977), the Federal Power Commission ceased to exist on September 30, 1977, and most of its functions and regulatory responsibilities were transferred to the Federal Energy Regulatory Commission, which, along with the Department of Energy, was activated on October 1, 1977.

218. At the time that Natural made its loans, the advanced payment program was embodied in a series of ICC orders: Order No. 410, 44 F.P.C. 1142 (1970); Order No. 410-A, 45 F.P.C. 135 (1971); Order No. 441, 46 F.P.C. 1178 (1971); Order No. 465, 48 F.P.C. 1550 (1972); Order No. 499, 50 F.P.C. 2111 (1973). The program was terminated in Order of December 31, 1975 (Dckt. Nos. R-411 and RM74-4), issued on remand of Order No. 499 from United States Court of Appeals for the District of Columbia. See *Public Serv. Comm'n v. Federal Power Comm'n*, 511 F.2d 338 (D.C. Cir. 1975). Nevertheless, advanced payment contracts entered into prior to termination retain their vitality and continued administration of the program will be required as pipeline companies file requests with the FERC for appropriate rate increases.

219. Hereinafter referred to as FERC.

220. See, e.g., Order No. 428, 45 F.P.C. 454 (1971) (exempting from direct rate regulation independent producers of natural gas with annual jurisdictional sales of less than 10,000,000 Mcf at 14.65 psia) and Order No. 491, 50 F.P.C. 742 (1973) (exempting from certification requirements and direct rate regulation intrastate producers of natural gas making sales during a 180-day period to pipelines experiencing or expecting curtailment). Order No. 428 was set aside by the United States Supreme Court in *Federal Power Comm'n v. Texaco, Inc.*, 417 U.S. 380 (1974) and Order No. 491 was set aside by the United States Court of Appeals for the District of Columbia in *Consumer Fed. of America v. Federal Power Comm'n*, 515 F.2d 347 (D.C. Cir. 1975).

221. See M. LEE, *STATE/FEDERAL REGULATION OF NATURAL GAS* (originally printed by the State of Texas Governor's Energy Advisory Council, October 29, 1974; available at the Southern Illinois University Law School library); Breyer & MacAvoy, *The Natural Gas Shortage and the Regulation of Natural Gas Producers*, 86 HARV. L. REV. 9 (1973); MacAvoy, *The Regulation-Induced Shortage of Natural Gas*, 14 J. LAW & ECON. 167 (1971).

222. See *Public Serv. Comm'n v. Federal Power Comm'n*, 511 F.2d 338, 340 (D.C. Cir. 1975).

limit the revenue of a public utility company to that which the company will require to meet necessary operating expenses and earn a reasonable return on some dollar measure of its "rate base."²²³ The rate base usually consists of the capital prudently invested in the physical assets used by the company to provide service during a "test year."²²⁴ The test year is typically the most recent twelve-month period for which complete operating data is available.²²⁵

A public utility company subject to traditional rate regulation will have a strong incentive to inflate its rate base if it will increase its net revenues by doing so. A public utility is likely to do just that if it possesses unexploited monopoly pricing power and is permitted to earn a rate of return in excess of its marginal cost of capital.²²⁶ A company with an incentive to inflate its rate base will tend to invest capital in physical assets that add to or replace the producing capacity of existing assets, but that need not be so. It would invest capital in any item that its regulatory authority would consider in determining its rate base.

The FERC declared, in the orders constituting its advanced payment program, that it would consider loans like Natural's in determining a pipeline company's rate base if the funds involved were appropriately expended within a "reasonable time" after the company disbursed them.²²⁷ Under this program, a pipeline company with an incentive to inflate its rate base could do so by loaning exploration and development capital to natural gas producers. This is exactly what the FERC wanted pipeline companies to do²²⁸ and the companies complied with the FERC program.²²⁹

223. *Missouri ex rel. Southwestern Bell Tel. Co. v. Public Serv. Comm'n*, 262 U.S. 276, 289 (1922) (separate opinion of Brandeis, J.). See generally KAHN, *supra* note 31, at 25-54.

224. *Id.*

225. *Id.*

226. Averch & Johnson, *Behavior of the Firm Under Regulatory Constraint*, 52 AMER. ECON. REV. 1052 (1962); Wellisz, *Regulation of Natural Gas Pipeline Companies: An Economic Analysis*, 71 J. POL. ECON. 30 (1963).

Both conditions must prevail. If the company had exploited all of its monopoly pricing power, it already would have maximized its net revenues. Since it could not increase them by inflating its rate base, it would have no incentive to try and do so. If the company were limited to a rate of return less than its marginal cost of capital, it would tend to lose more than it would gain by disbursing capital. Since it would stand to decrease its net revenues by inflating its rate base, it would have no incentive to try and do so.

The tendency of public utility companies subject to traditional rate regulation to inflate their rate bases is called the "A-J-W effect." It would appear to be widespread. See 2 A. KAHN, *THE ECONOMICS OF REGULATION* 49-59 (1971).

227. Order No. 499, 50 F.P.C. 2111, 2115 (1973).

228. *Public Serv. Comm'n v. Federal Power Comm'n*, 467 F.2d 361, 363 (D.C. Cir. 1972).

229. A report prepared on the basis of data collected by the ICC showed a total of \$5.5 billion had been committed to similar loans as of February 1, 1976. *Tennessee Gas Pipeline Co. v. Federal Energy Regulatory Comm'n*, 606 F.2d 1094, 1105 (D.C. Cir. 1979).

It would appear, then, that Natural's management was not patently unreasonable in expecting the FERC to permit Natural to raise its rates in order to recoup²³⁰ at least the costs of financing its loans. Yet, the FERC frustrated those expectations.²³¹ The FERC decided to exclude from Natural's rate base all but about \$1 million of the loaned funds and, accordingly, deny, in part, Natural's request for higher rates.²³² The FERC reached its decision on the ground that the other \$5.7 million, having been expended more than thirty days after the end of the test year, had not been expended within a "reasonable time" after Natural disbursed the funds.²³³

The Seventh Circuit's Approach

In *Natural Gas Pipeline Co. of America v. Federal Energy Regulatory Commission*,²³⁴ the Seventh Circuit reversed the FERC's decision.²³⁵ The court held that, in reaching the decision, the FERC had indulged in the unlawful practice of retroactive rate-making.²³⁶ That holding could not be questioned if the FERC had 1) found that Natural's old rates, although previously approved, were too high, 2) ordered that lower rates be substituted for the old ones, and 3) required that Natural refund to its customers the difference between the old and the new rates. Such action by the FERC would have been quite illegal²³⁷

230. If Natural were permitted to earn a rate of return in excess of its marginal cost of capital, it could expect to not only recoup the costs of financing the loans, but to turn a profit as well.

231. *See* *Natural Gas Pipeline Co. of America v. Federal Energy Regulatory Comm'n*, 590 F.2d 664, 665 (7th Cir. 1979).

232. Natural's request for higher rates was based only in part on the loans it had made to the producers. Issues unrelated to the loans were disposed of in a settlement agreement.

233. *Natural Gas Pipeline Co. of America*, FPC Docket No. RP73-110 (June 3, 1977) (unpublished order of Federal Power Commission modifying initial decision).

234. 590 F.2d 664 (7th Cir. 1979).

235. *Id.* at 670.

236. In its opinion, the court also faulted the ICC for failing to give pipelines like Natural sufficient guidelines for making loans to producers. *Id.* at 669-70. It is not entirely clear whether the court took the view that this alleged failure supported its holding or constituted an independent ground for reversing the ICC decision. If the court was of the latter view, it was clearly mistaken. It is perfectly permissible for the ICC to subject pipeline companies to the risk that expenditures they choose to make may later be determined unjust and unreasonable. *Federal Power Comm'n v. Texaco, Inc.*, 417 U.S. 380, 391-92 (1974). *But see* *Consumer Fed'n of America v. Federal Power Comm'n*, 515 F.2d 347, 359 (D.C. Cir. 1975). The United States Court of Appeals for the District of Columbia Circuit subsequently stated, "we did not intend *Consumers Federation* to express a general solicitude for all pipelines caught in a 'squeeze' to obtain gas." *Tennessee Gas Pipeline Co. v. Federal Energy Regulatory Comm'n*, 606 F.2d 1094, 1116 (D.C. Cir. 1979).

237. *Cf. Arizona Grocery Co. v. Atchison, Topeka & Santa Fe Ry.*, 284 U.S. 370, 389 (1932) (the Court held that the ICC had acted illegally when it took similar action against a railroad company).

and not at all authorized by the governing statute.²³⁸ In addition, such action would have been very unfair to Natural²³⁹ and contrary to the immediate goal of rate regulation, would have made the pipeline business so risky that the cost of capital might have boosted rates to monopolistic levels. The FERC, however, did not, in fact, engage in any such action. Rather, the FERC merely excluded an item from Natural's rate base and did so in the process of setting, prospectively,²⁴⁰ Natural's just and reasonable rates. Apparently, the court objected to the exclusion as retroactive rate-making because it was based on a rule, the "thirty-day rule," that had not been announced in any of the orders that then constituted the advanced payment program.²⁴¹

The Seventh Circuit's objection was not well-taken. The choice of whether to act in an adjudicatory proceeding on the basis of a rule previously promulgated in an informal rulemaking was well within the FERC's discretion.²⁴² It does not appear that the FERC abused this discretion. Indeed, it could be argued that the FERC made its choice judiciously. Consider three factors. First, the "thirty-day rule" represented a refinement of, not a departure from, the "reasonable time" proviso contained in the advanced payment program orders.²⁴³ Second, it is not at all clear that Natural's management, in making the loans, reasonably relied on the non-existence of the rule.²⁴⁴ Natural's

238. 42 U.S.C. §§ 717(c), 717(d) (1976).

239. *Cf.* NLRB v. Majestic Weaving Co., 355 F.2d 854 (2d Cir. 1966). Majestic negotiated with a union before a majority of its employees had affiliated themselves. The Board, overruling an earlier decision of longstanding, found that Majestic had provided "unlawful assistance to a union" in violation of 29 U.S.C. § 158(a)(2) (1976). The court overturned the Board's decision and noted, in dictum:

Although courts have not generally balked at allowing administrative agencies to apply a rule newly fashioned in an adjudicative proceeding to past conduct, a decision branding as "unfair" conduct stamped "fair" at the time a party acted, raises judicial hackles considerably more than a determination that merely brings within the agency's jurisdiction an employer previously left without, . . . or shortens the period in which a collective bargaining agreement may bar a new election, . . . or imposes a more severe remedy for conduct already prohibited . . .

355 F.2d at 860.

240. Although the ICC's decision was rendered in 1977, long after the period for which the higher rates requested by Natural would have been effective, it was rendered from a prospective view. Natural's management clearly understood that the rates it was permitted to charge in the interim were subject to refund. 590 F.2d at 665.

241. *Id.* at 669-70.

242. NLRB v. Bell Aerospace Co., 416 U.S. 267, 294 (1974).

243. The degree of "retroactivity" is an important consideration in determining whether a regulatory authority has abused its discretion by acting in an adjudicatory proceeding on the basis of a rule not previously promulgated in an informal rulemaking. *See* SEC v. Chenery Corp., 332 U.S. 194, 203 (1947); NLRB v. Majestic Weaving Co., 355 F.2d 854, 861 (2d Cir. 1966).

244. Unless Natural's management, in making the loans, reasonably relied on the non-existence of the rule, there could be little, if any, justification for denying the ICC the administrative flexibility it apparently perceived that it needed in handling the timing problem. *See* Order Denying Rehearing of Order No. 499, 51 F.P.C. 818, 819 (1974).

management knew or should have known that fundamental regulatory principles would, in any event, require that it justify the inclusion of the loans in its rate base.²⁴⁵ Third, the hardship that the application of the rule caused Natural was not as great as it might appear.²⁴⁶ The exclusion really amounted to a mere deferral rather than an outright ban on rate base treatment.²⁴⁷

Whenever a regulatory authority engaged in traditional rate regulation excludes an item from a public utility company's rate base, it acts, in a sense, retroactively.²⁴⁸ The regulatory authority refuses to take into consideration one or more of the company's past expenditures for the purpose of calculating required revenues. But a regulatory authority must be able to do just that if it is to exercise any meaningful control over the company's revenues and expenditures.²⁴⁹ The regulatory authority must exercise that control if it is to have any chance of doing its basic job which is to obtain from the company an economic performance superior to that expected from an unregulated monopolist. In *Natural Gas Pipeline Co. of America v. Federal Energy Regulatory Commission*,²⁵⁰ the Seventh Circuit limited the ability of regulatory authorities to exclude items from rate bases, control revenues and expenditures—in short, to do their jobs—and the court did so unnecessarily.

The court could have reached the same result without holding that the FERC had indulged in retroactive rate-making. To do so, the court would have had to undertake an economic analysis of the advanced payment program. When a pipeline company agrees to make interest-free loans, as did Natural, it, in effect, agrees to pay a higher price for the gas it expects to purchase from the recipient producers. By agreeing to pay a higher price, the pipeline company will likely call forth a

245. See *Federal Power Comm'n v. Texaco, Inc.*, 417 U.S. 380, 391 (1974); *Tennessee Gas Pipeline Corp. v. Federal Energy Regulatory Comm'n*, 606 F.2d 1094, 1115 (D.C. Cir. 1979); KAHN, *supra* note 31, at 26-35.

246. The extent of the hardship caused is also an important consideration in determining whether a regulatory authority has abused its discretion by acting in an adjudicatory proceeding on the basis of a rule not previously promulgated in an informal rulemaking. *NLRB v. Bell Aerospace Co.*, 416 U.S. 267, 295 (1974).

247. *Tennessee Gas Pipeline Corp. v. Federal Energy Regulatory Comm'n*, 606 F.2d 1094, 1108 (D.C. Cir. 1979). Eventually, as the funds were expended, the excluded portion of the loans would be included in the rate base.

248. See, e.g., *City of Los Angeles v. Public Utils. Comm'n*, 7 Cal. 3d. 331, 497 P.2d 785, 102 Cal. Rptr. 313 (1972); *New England Tel. & Tel. Co. v. Department of Pub. Utils.*, 275 N.E.2d 493 (Mass. 1971).

249. KAHN, *supra* note 31, at 26-35.

250. 590 F.2d 664 (7th Cir. 1979).

greater supply of gas²⁵¹ while, at the same time, practically requiring a boost in its own rates. The "thirty-day rule" did not meaningfully distinguish between those loans that probably would call forth a greater supply of gas without boosting pipeline rates unreasonably and those loans that probably would not do so.²⁵² The "thirty-day rule" bore no clear relation to the economic function of the advanced payment program, and so, any decision based on it would have been arbitrary and capricious.²⁵³ The Seventh Circuit in *Natural Pipeline Co.* should have so held.

CONCLUSION

Analyzing statutes and rules in terms of their economic function can be, as any reader of this article could attest, painfully intricate, intellectually exhausting legal work. Nevertheless, courts must bear the responsibility of doing that work as long as legislatures and administrative agencies persist in using law to control major business decisions. Otherwise, policies with important economic ramifications may be rendered nugatory and the shibboleths of administrative law may be found to be meaningless. Unfortunately, in the four major regulatory cases the court decided during the 1978-79 term, the Seventh Circuit did not quite meet its responsibility.

251. Higher prices would not call forth a greater supply of gas only under conditions of complete inelasticity of supply. It would appear that such conditions do not prevail in the natural gas market. STAFF OF SENATE INTERIOR & INSULAR AFFAIRS COMM., 93RD CONG., 1ST SESS., NATURAL GAS POLICY ISSUES AND OPTIONS, (Comm. Print 1973) 32-33; REGULATION OF THE NATURAL GAS PRODUCING INDUSTRY 3-5 (1972).

252. The "thirty-day rule" was based on the ICC observation that producers were normally permitted thirty days from the date of billing to pay for contract work and materials. *Tennessee Gas Pipeline Co. v. Federal Energy Regulatory Comm'n*, 606 F.2d 1094, 1105 (D.C. Cir. 1979). The ICC never explained what relationship conventional credit-sale terms bore to the economic function of the advanced payment program.

253. *Cf. Tennessee Gas Pipeline Co. v. Federal Energy Regulatory Comm'n*, 606 F.2d 1094, 1118-19 (D.C. Cir. 1979) (finding that the ICC had been unduly restrictive in decisions based on the "thirty-day rule" because it failed to take account of all factors relevant to the timing problem).