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THE STAGGERS RAIL ACT OF 1980: DEREGULATION GONE AWRY

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I. INTRODUCTION

Congress enacted the Staggers Rail Act of 1980 (the Act) to remove "unnecessary and inefficient" regulations and deregulate the competitive segments of the railroad industry. This legislative effort to return certain portions of the industry to the market-directed sector of the economy is conceptually appealing. Because regulation was presumably imposed to protect the public from monopoly abuses,¹ it should logically be eliminated in areas where effective competition arises. In theory, allowing the market to operate freely in these areas should result in a more efficient allocation of resources and social welfare gains. Unfortunately, the scheme of partial deregulation adopted in the Staggers Act is likely to produce opposite results: a decline in allocative efficiency and social welfare losses. More specifically, the Act directly injures certain shippers who are left unprotected from the monopoly power of the railroads.

This article is focused on two critical elements of the Staggers Act: the jurisdictional threshold ratios and the revenue adequacy provisions.

II. JURISDICTIONAL THRESHOLDS AND REVENUE ADEQUACY

To facilitate its policy of partial deregulation, Congress developed a test of market dominance for individual rail shipments. Actually, the concept of market dominance was already incorporated in the Interstate Commerce Act

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¹ For instance, predatory pricing and unfair price discrimination were major factors in initiating governmental regulation of the railroads. Prior to regulation, railroads often charged higher rates for shorter routes than for longer ones, even when the traffic was similar in nature and carried over the same line and in the same direction. As described in LETWIN's book, *AMERICAN ECONOMIC POLICY SINCE 1789* (1961), this pricing scheme evolved as a result of competition between railroads and barges along certain routes: "In this competition of boat and railroad the rates of transportation which were directly controlled by it soon reached a point to which the railroads could not possibly have reduced all their tariffs and still maintain a profitable existence. They did not attempt such a reduction, but on the contrary, while reducing their rates at the points of water competition to any figures that should be necessary to enable them to obtain the freights, they kept them up at all other points to such figures as they deemed the service to be worth, or as they could obtain. It often happened, therefore, that the rates for transporting property over the whole length of a road to a terminus on a water highway would not exceed those for the transportation for half the distance only, to a way station not similarly favored with competition." (185-86). The Interstate Commerce Act subsequently prohibited such inequitable pricing schemes, until this prohibition was potentially nullified by the passage of the Staggers Act.

through the 4-R Act of 1976.² Market dominance means an absence of effective competition from other carriers or modes of transportation for the transportation to which a rate applies.³ The existing law provided that the Interstate Commerce Commission could not suspend an increase in a carrier's rate if it did not first determine that the carrier had market dominance over the shipment in question. No guidelines were provided for determining whether or not market dominance was present. Hence, the ICC could consider all relevant factors.

The Staggers Act added a stringent test for market dominance by inserting specific revenue-variable cost ratios called jurisdictional thresholds. The initial threshold ratio was 160 percent, which remained in effect for one year from October 1, 1980 to September 30, 1981. For each successive year, the Act provides an annual increase of five percentage points, until a maximum 180 percent threshold is reached. If a particular rate produces a revenue-variable cost ratio lower than the relevant threshold ratio for that year, then the ICC "shall find that the rail carrier establishing the challenged rate does not have market dominance over the transportation to which the rate applies."⁴ Thus, under the Staggers Act, rates which are below the jurisdictional threshold ratio are automatically outside the ICC jurisdiction, because the carrier is presumed to face effective competition along that particular route.

Rates which equal or exceed these threshold ratios may be within the jurisdiction of the Interstate Commerce Commission. Above the thresholds, the Commission must evaluate other relevant factors, such as geographic or intermodal competition.^{4a} Hence, such rates may or may not be subject to ICC regulation, depending upon the Commission's findings about market dominance.

In determining the reasonableness of a rate in the ICC's jurisdiction, the Staggers Act directs the Commission to "recognize the policy of this title that rail carriers shall earn adequate revenues."⁵ Previous legislation (the 4-R Act) charged the ICC to maintain standards for establishing revenue levels for railroads that are adequate ". . . to cover total operating expenses . . . plus a reasonable and economic profit or return (or both) on capital employed in the business."⁶ The Commission was also required "to make an adequate and continuing effort to assist those carriers in attaining . . . [adequate] revenue levels."⁷ The Staggers Act did not alter these elements of the law. Thus, although the ICC is prohibited from regulating certain portions of a railroad's business, it must continue to assist the railroad in attaining "adequate" reve-

² The Railroad Revitalization and Regulatory Reform Act of 1976, Pub. L. 94-210 90 Stat. 210 (codified in scattered sections of 46 and 49 U.S.C.).

³ 49 U.S.C. § 10709 (a) (Supp. IV 1980).

⁴ 49 U.S.C. § 10709(d)(2) (Supp. IV 1980).

^{4a} Market Dominance and Consideration of Product Competition, *Ex Parte* No. 320 (Sub. No. 2) I.C.C. 118 (1981).

⁵ 49 U.S.C. § 10701a(b)(3) (Supp. IV 1980).

⁶ 49 U.S.C. § 10704(a)(2) (Supp. IV 1980).

⁷ 49 U.S.C. § 10704(a)(2) (Supp. IV 1980).

nues on its *overall* operations, including these unregulated segments.⁸

The regulatory scheme created by the Staggers Act has three major flaws. First, the jurisdictional threshold ratios are not a valid test of market dominance. Second, the threshold ratios and the revenue adequacy provisions preclude consideration of other relevant factors which might indicate that a rate is unreasonable. Thus, the Staggers Act removes regulatory protection in areas where it is still necessary to prevent excessive rates and other monopoly abuses. And third, the jurisdictional threshold ratios allow the railroads to unduly influence the bounds of ICC regulation over their rates and act as an incentive for waste and inefficiency in railroad operations.

III. THE THRESHOLD RATIOS: AN INVALID TEST OF MARKET DOMINANCE

As envisioned in the 4-R Act of 1976, a market dominance criterion for establishing the extent of ICC jurisdiction is a reasonable approach to partial deregulation. In fact, a conceptually similar method has been successfully introduced into telecommunications where deregulation has been implemented in specific segments of the industry where competition could viably exist with little or no governmental intervention.⁹ However, unlike the approach taken in the telecommunications industry, the Staggers Act establishes a numerical "benchmark"—the jurisdictional threshold ratio—as the primary test of market dominance. The introduction of this single factor for determining the extent of ICC jurisdiction is perhaps the most serious flaw in the Staggers Act. Because the jurisdictional threshold ratio is not a valid test of market dominance, the basis for deregulation under the Staggers Act is unsound.

One indicator of the inappropriateness of the threshold ratios is the excessive earnings which would result if all railroad rates were set at these levels. Assuming a 46 percent effective tax rate, the following earnings would result:

<u>Threshold Ratio</u>	<u>Returns on Investment</u>	<u>Return on Equity</u>
160%	16.83%	21.38%
165%	18.56%	24.56%
170%	20.28%	27.14%
180%	23.74%	32.89%

⁸ This approach to partial deregulation contrasts sharply to the one used in the telecommunications industry, where regulators are required to provide the opportunity for a fair rate of return only in the regulated segments of a firm's business.

⁹ In its Final Decision in the *Second Computer Inquiry* 77 F.C.C. 2d 384 (May 2, 1980), the FCC deregulated "enhanced" network services, based on its findings that ". . . the absence of traditional public utility regulation of enhanced services offers the greatest potential for efficient utilization and full exploitation of the interstate telecommunications network." 77 F.C.C.2d at 387. Likewise, customer-premises products (CPE) were detariffed, based on the FCC's conclusion that "[T]here is nothing inherent in any carrier-provided CPE, including the basic telephone that necessitates its provision as an integrated part of a carrier's regulated transmission service." 77 F.C.C. 2d at 441.

These returns, based on Charles L. Carroll's calculations,¹⁰ are considerably higher than the normal range of earnings in other industries over the past decade. (See Table 1). Only a small minority of unusually profitable industries have ever achieved earnings which approximate the level for railroads under even the lowest 160 percent threshold ratio, and none of the industries approach the extremely high returns possible under the maximum threshold of 180 percent. The very few with extraordinary returns are usually risky or lucky firms which deviate from the normal pattern or benefit from patents and other sources of monopoly power.

TABLE 1
RETURNS ON AVERAGE EQUITY¹¹

	1977-81			1972-81		
	High	Low	Average	High	Low	Average
<i>Business Week</i> 40 Industries:						
Highest Industry Return	24.8%				NA	
Lowest Industry Return		-11.1%			NA	
40 Industry Composite	14.0%	16.6%	15.0%		NA	
Standard & Poor's 400 Industrials	17.2%	14.6%	15.5%	17.2%	12.0%	14.2%
Federal Trade Commission						
All Manufacturers	16.5%	13.7%	14.7%	16.5%	10.6%	13.8%
Moody's 24 Utilities	12.3%	10.7%	11.2%	12.3%	10.4%	11.0%
Moody's 9 Gas Distribution Companies	14.6%	13.5%	14.1%	14.6%	11.8%	13.2%

Most railroads will not earn the extraordinary returns that would result if all of their rates were set at the jurisdictional thresholds, because they will tend to price their competitive traffic well below the threshold levels. Nevertheless, the fact that the threshold ratios allow these abnormally high profit levels makes them an inappropriate test for market dominance. Obviously, a railroad must have a considerable degree of monopoly power to set its rates at a level yielding a return on equity of 27.14 percent, when most other industries are earning less than 15 percent. Regulated firms are not entitled to the high profits earned by firms possessing substantial monopoly power—a result sanctioned under the Staggers Act.

The conclusion that the threshold ratios are an invalid test of market dominance is further evidenced by the fact that the Staggers Act is vague and indefinite about the proper calculation of the ratios, particularly the variable cost component. The Act provides only that “. . . variable costs shall be deter-

¹⁰ Charles L. Carroll, *Verified Statement*, on behalf of Nevada Power Company, No. 37038 at 7 (I.C.C. Nov. 9, 1981).

¹¹ “Moody's Public Utility Manual, 1977-82; Federal Trade Commission, *Quarterly Financial Report for Manufacturing, Mining, and Trade Corporations, 1959-82*; Standard & Pears Statistical Service, August 1980, October 1981, September 1982; *Business Week*, March 20, 1978, March 4, 1979, March 17, 1980, March 16, 1981, March 15, 1982.

mined pursuant to section 10705a(m)(1) of this title, with adjustments specified by the Commission.”¹² The referenced section offers little additional guidance: “Variable costs . . . shall be determined . . . by . . . unadjusted costs calculated using the Commission’s Rail Form A cost finding methodology (or an alternative methodology adopted by the Commission in lieu thereof).”¹³ The law fails to set standards or guidelines for application of the ICC Rail Form A costing methodology or alternative costing techniques. Thus, the legislation effectively allows the ICC to use any methodology in calculating variable costs.¹⁴

The paradox in the Act is apparent. Congress relied upon a rigid revenue-variable cost criterion for deciding that carriers lack market dominance, without knowing specifically how variable costs would be defined and calculated. Congress could not anticipate that rates below a certain revenue-cost ratio indicate a lack of market dominance, without specifying how costs were to be defined or measured. This failure to develop an explicit methodology for the calculation of variable costs is particularly disturbing in view of the difficulties with measuring the cost of individual rail movements.

The railroads have indicated that they generally do not know the actual cost (variable, marginal, or otherwise) of specific movements.¹⁵ Rail Form A does not report costs in this manner either. It merely develops average variable unit costs.¹⁶ The average variable costs for a given movement can be calculated by multiplying these system-wide average costs by the number of traffic service units for the movement. However, this calculation does not necessarily reflect the individual costs incurred in moving a commodity from point A to point B, because it incorporates the average costs per service unit for all shipments. Hence, the average-oriented Rail Form A methodology will generally overstate the variable cost for shipments which are actually moved at unit costs below the system average and understate the cost for shipments which are actually moved at unit costs above the system average.

¹² 49 U.S.C. § 10709(d)(3) (Supp. IV 1980).

¹³ 49 U.S.C. § 10705a(m)(1) (Supp. IV 1980).

¹⁴ As of this writing, the ICC has generally relied upon adjusted Rail Form A cost data for the calculation of variable costs. *See, e.g.,* *Western Farmers Elec. Coop. v. Burlington N. R.*, No. 38738, decided November 10, 1982; *International Minerals & Chem. Corp. v. Burlington Northern Inc.*, No. 38084S; decided November 4, 1982; and *Aggregate Volume Rate on Coal Acco, Utah to Moapa, Nev.*, No. 37409, decided February 6, 1981. The adjustments to Rail Form A costs are typically decided on a case-by-case basis. A new costing methodology, the Uniform Rail Costing System, is currently being developed, and will probably replace Rail Form A for measuring variable costs. *See infra* note 17.

¹⁵ For example, in Docket No. 37038 before the ICC, both the Utah Railway and the Union Pacific Railroad were asked by Nevada Power Company, the complainant, to supply copies of their marginal costs analyses. These studies are necessary to accurately price railroad shipments in an economically efficient manner; yet neither railroad had such studies. Union Pacific’s lack of concern for accurate cost information was further evidenced, when it was asked to supply basic information concerning the revenue-variable cost relationships for various types of shipping which have historically been identified as noncompensatory or marginally profitable. In its July 29, 1981 reply to Nevada Power Company’s First Set of Interrogatories [Number 15(q)], the railroad replied: “. . . This information is unavailable and would be unduly burdensome to develop.”

¹⁶ John M. Anderson, *Verified Statement*, on behalf of Nevada Power Company, No. 37038 at Appendix G, p. 10 (I.C.C. Nov. 9, 1981).

The ICC is currently developing a new procedure, the Uniform Rail Costing System (URCS), which will probably replace Rail Form A for calculating variable costs.¹⁷ Variable costs calculated under the URCS may exceed those computed using Rail Form A. If so, a carrier with market dominance under the old costing methodology (when its revenue-variable cost ratio for a particular shipment was above the jurisdictional threshold) might automatically be presumed *not* to be dominant under the new methodology. Because Congress did not clearly specify a method for calculating variable costs, the market dominance test established in the Staggers Act is meaningless.¹⁸

Even if Congress had defined variable costs, the jurisdictional threshold ratios would not be a valid test of market dominance, nor an appropriate standard for deregulation. None of the ratios are supported by either theoretical or empirical evidence. In fact, comments in the Congressional Record on the day of the Act's passage suggest that the particular ratios chosen were simply the result of an arbitrary compromise. For instance, Congressman Rahall of West Virginia stated: "This compromise amendment starts at the previously adopted Ekhardt-Rahall threshold level of a 160 percent revenue-variable cost percentage . . . [which] compares with the original 200 percent threshold level that previously existed in the original bill."¹⁹

There is no documentation which supports the development of the 160 percent initial threshold ratio, the alternative 200 percent ratio, or any of the intermediate ratios included in the Act. Congress apparently wanted to establish guidelines for railroad deregulation and arbitrarily chose these threshold ratios as a means towards that end. Congressman Madigan of Illinois stated: "The compromise we have before us today provides for deregulation in orderly stages by raising the jurisdictional threshold level of the ICC from a starting point of 160 percent with annual increments of 5 percent up to 180 percent of variable costs."²⁰ However, Congressman Madigan offered no rationale for these particular threshold ratios or any revenue-variable cost ratios. No studies have been conducted which demonstrate that effective competition exists when rail carriers price below 160 percent of variable cost. Likewise, the higher threshold ratios in subsequent years are not indicative of an increase in the degree of effective competition. These figures chosen by Congress are simply arbitrary benchmarks designed to keep the ICC from "proceed[ing] headlong

¹⁷ R. Dart, *Railroad Costs: How Much is Vital Question for Shippers and Carriers*, TRAFFIC WORLD, July 20, 1981, at 32; Anderson, Appendix G, p. 9.

¹⁸ It is interesting to note a report by the Congressional Subcommittee on Oversight and Investigations (hereinafter known as the Subcommittee Report) concluded prior to the enactment of the Staggers Act that "[e]xclusive reliance on the ICC's computation of cost of service, including rate of return . . . variable cost or fully allocated cost is not sound; indeed it would be inappropriate to rely on any single revenue-to-cost ratio based on ICC cost computations." Despite this warning, Congress approved a scheme of deregulation which relies solely on revenue-variable cost ratios without specifying any costing methodology. *Railroad Coal Rates and Public Participation: Oversight of ICC Decisionmaking*, Committee on Interstate and Foreign Commerce, House of Representatives, 96th Cong. 2d Sess. (February 1980) [hereinafter cited as *Railroad Coal Rates*].

¹⁹ Cong. Rec. 8551 (Sept. 9, 1980).

²⁰ *Id.* at 8556.

into deregulation without guidelines."²¹

Furthermore, the jurisdictional threshold ratios cannot be a valid test of market dominance because every single rail shipment and every single carrier is subject to the same ratios. Each carrier operates under different circumstances with a different mix of variable and fixed expenses. Rail carriers also operate under different cost conditions than competing carriers, such as trucks and barges. Hence, two rail shipments with widely varying degrees of competition may produce identical revenue-variable cost ratios; while two shipments with identical competitive conditions can have widely disparate revenue-variable cost ratios. Any single set of threshold ratios must necessarily be arbitrary and capricious, if it is applicable to widely varying circumstances.

In sum, the jurisdictional threshold ratios are an unsupported and inappropriate test for determining the degree of effective competition for individual rail shipments. Rates set at or just below the threshold ratios allow the railroads to earn excessive returns which are indicative of market dominance. Moreover, the vague and indefinite language in the Staggers Act makes the calculation of revenue-variable costs ratios for individual rates dependent upon the costing methodology selected by the ICC. Since Congress failed to define a methodology for calculating variable costs, it had no logical basis for concluding that rates below the threshold ratios are amenable to deregulation. Although they are presented as a test for market dominance, the threshold ratios are actually nothing more than an arbitrary set of guidelines developed by Congress to phase in deregulation in the railroad industry. As such, they have no economic basis.

IV. EXCLUSION OF OTHER RELEVANT FACTORS

By instituting a rigid standard for determining ICC jurisdiction, the Staggers Act precludes consideration of other relevant factors concerning the reasonableness of rail rates. In the case of coal shipping rates, the Commission is left in a quandary. On the one hand, it is required by the Staggers Act "to encourage and promote energy conservation."²² As indicated in its Conference Report on the Act, Congress intended this policy to "include the encouragement and promotion of the transportation of coal by rail in accordance with the objective of energy independence. . . ."²³ On the other hand, however, the ICC cannot consider the impact of high coal shipping rates on national energy policy, as long as these rates do not exceed the jurisdictional threshold. Moreover, even if the rates exceed the threshold, the Commission's responsibility to assist the railroads in attaining revenue adequacy may prevail over other concerns. Hence, any consideration of the impact upon coal shipping rates is likely to be perfunctory.²⁴

²¹ *Id.* at 8551.

²² 49 U.S.C. § 10101a(15) (Supp. IV 1980).

²³ H.R. Con. Rep. No. 96-1430 at 80, *reprinted in* 1980 U.S. CODE CONG. & AD. NEWS 3979.

²⁴ For instance, in recent cases involving coal shipping rates, the ICC has emphasized its statutory requirements to assist the railroads in attaining revenue adequacy. However, its consideration of energy conservation has generally been limited to the unsupported conclusion that its deci-

In fact, in interpreting the Staggers Act, the ICC may conclude that its duty to assist the carriers in attaining revenue adequacy supersedes all other considerations concerning the reasonableness of rates above the jurisdictional threshold. For instance, the Commission recently overturned a ruling by the Public Service Commission of Indiana that the rate proposed by Louisville and Nashville Railroad Company, which produced a 202 percent revenue-variable cost ratio, was above a maximum reasonable level. The Indiana Commission's decision was based in part on its findings that the L&N was inefficiently managed. In its order rescinding this decision, the ICC stated: "In using the questionable findings of inefficient management to avoid genuine consideration of revenue adequacy, PSCI violated one of the most important Federal Standards—one that permeates the present statutory scheme of railroad rate regulation. We conclude that the PSCI failed to give proper consideration to revenue adequacy."²⁵

In a subsequent case involving aluminum shipments on the Bauxite and Northern Railway Company, the initial order by Administrative Law Judge James E. Hopkins stated: "The Rail Transportation Policy enunciated in the Staggers Act appears generally in its overall content to allow the railroads to set their rates at whatever level they consider reasonable as long as they are not revenue adequate. Until they reach revenue adequacy . . . it does not appear that a rail carrier rate no matter how high can be considered above a maximum reasonable level."²⁶ Congress may not have intended this one-dimensional approach to regulation. In that case, the ambiguities in the law should be eliminated to avoid such misinterpretations.

V. REMOVAL OF REGULATORY PROTECTION FOR CAPTIVE SHIPPERS

Because of these fundamental flaws in the Staggers Act, regulatory protection against excessive rates is stripped away in areas where the railroads enjoy monopoly power. Coal shippers, who are typically dependent upon the railroads for their transportation needs, are particularly hard hit. A report by the Congressional Subcommittee on Oversight and Investigations highlighted the extent of the railroads' market dominance in this area:

Virtually every generating plant consuming western coal is captive for transportation services to a single railroad possessing monopoly power or acting in a cartel arrangement.

. . . .

In the East, the availability of competing transportation modes over substantial distances is limited to coal users and suppliers located near inland or coastal waterways. Truck competition only exists for coal haulages over short

sion "does not significantly affect the quality of the human environment or the conservation of energy resources." See e.g., *Aggregate Volume Rate on Coal, Acco, Utah to Moapa, Nev.*, No. 37409, Slip. op. at 8 (I.C.C. Nov. 9, 1981, and prior decisions decided Feb. 6, and 9, and Mar. 18, 1981). *Aluminum Co. of Am. v. Bauxite & N. R.R. Co.*, No. 37801S, (I.C.C. Dec. 16, 1982).

²⁵ *Louisville and Nashville R.R. Co.*, No. 38946, slip. op. at 5 (I.C.C. Nov. 22, 1982).

²⁶ *Aluminum Co. of Am. v. Bauxite & N. R.R. Co.*, No. 37081S, slip. op. at 5, (I.C.C. Dec. 16, 1982). See also *Coal Rate Guidelines, Nationwide, Ex parte No. 347 Sub. No. 1* (I.C.C. Feb. 8, 1983).

distances.

. . . .

In recent years, coal-hauling railroads have greatly increased their market power. . . .

. . . .

The bargaining power of most coal shippers is extremely weak. Usually, railroads simply announce their rates on a take-it-or-leave-it basis.²⁷

This report, issued prior to the passage of the Staggers Act, concluded: "Given current conditions in the coal transportation marketplace, competition should be encouraged and rate regulation should be retained in order to prevent monopoly profits."²⁸ Nevertheless, Congress adopted a scheme which removes regulatory protection in the coal shipping markets and does little to encourage competition in this area.

In fact, the jurisdictional threshold concept in the Staggers Act tends to promote excessive coal shipping rates by establishing an automatic price floor for captive shipping rates and fostering a mentality which encourages rates above this floor. From the railroads' perspective, it is rational to view the threshold ratio as a price floor for monopoly shipments. Knowing that captive shippers have nowhere else to turn for their transportation needs, the railroads have little or no reason to set their rates any lower than the applicable threshold, unless demand is sufficiently weak that the profit-maximizing monopoly price is below this level. Since the Staggers Act eliminates the threat of ICC intervention at rates below the jurisdictional thresholds, the railroads are free to charge monopoly rates for captive shipments.

Many railroads, as well as the ICC, appear to subscribe to the notion that the jurisdictional threshold ratios establish a floor for captive rail rates. For instances, in a recent case before the ICC involving a western coal shipment, Union Pacific Railroad stated: "These [jurisdictional threshold] provisions in the Staggers Rail Act clearly demonstrate Congress' intention that revenue-to-cost ratios serve as a *floor* for the Commission's determination of a reasonable rate, and not as a rate ceiling."²⁹ Moreover, in *Coal, Wyoming to Redfield, Arkansas*,³⁰ the ICC allowed the rate under consideration to be set at the jurisdictional threshold of 160 percent, even though the current rate with a revenue-variable cost ratio of 150.2 percent had previously been found reasonable. The Commission also indicated that the rate could be automatically raised after October 1, 1981 to the 165 percent threshold ratio applicable at that time.

Viewed as a rate floor, the threshold ratio tends to encourage even higher rates, by lending an air of respectability to proposals which might otherwise be judged unreasonable. For example, the western railroads proposed in their filing in *Ex parte* No. 347, *Coal Rate Guidelines—Nationwide*, that the ICC declare rates for coal shipments which fall between the jurisdictional threshold

²⁷ See *Railroad Coal Rates*, *supra* note 18, at 2.

²⁸ *Id.* at 7.

²⁹ *Opening Statement of Facts and Argument of Union Pac. R.R. Co. and Utah Ry. Upon Reopening*, No. 37038, slip. op. at 11 (I.C.C. Oct. 19, 1981).

³⁰ No. 37276 (Sub. No. 1) slip. op. (I.C.C. May 18, 1981).

ratio and 225 percent of variable costs to be "within a 'safe harbor' of reasonableness."³¹ Under their proposal, only coal shipping rates above the 225 percent ratio would be subject to consideration by the Commission. Hence, the western railroads proposed to establish a price floor for captive coal shipments at a level even higher than the already excessive jurisdictional thresholds mandated in the Staggers Act.

In another case involving a specific coal shipment, Union Pacific and Utah Railway suggested that the criteria for reasonableness in one year should anticipate the higher levels of future jurisdictional thresholds. The railroads insisted that "[i]t would be nonsensical for the Commission to be allowed to find a rate unreasonable today when that same rate would, by definition, be conclusively established to be reasonable in the near future."³²

These examples demonstrate the mentality fostered by the mere presence of the threshold ratios. As the jurisdictional thresholds shift upward, the railroads will be encouraged to propose still higher rates, continually increasing the burden on coal and other captive shippers. Moreover, the ICC is encouraged to accept these excessive rate proposals, to meet its legislative requirement to "make [a] . . . continuing effort to assist . . . carriers in attaining [adequate] revenue levels."³³

Recent orders by the I.C.C. support this conclusion. For instance, in his initial order in *Aluminum Co. of America v. Bauxite & Northern Railway Co.*,³⁴ Judge Hopkins concluded:

"Until the carriers are revenue adequate as determined by the I.C.C. no rate in this Judge's opinion can be found to be above maximum reasonable level. . . . [This] conclusion . . ., while simple in its concept can be devastating in its execution. Individual shippers and receivers captive to an individual railroad can be forced to pay an exorbitant sum for transportation. . . ."³⁵

Based upon his conclusions about the legal requirements of the Staggers Act, Judge Hopkins ruled that "since the Commission has found the carriers . . . not to be revenue adequate, the rate complained of herein [which produced a 195 percent revenue-variable cost ratio] has not been shown to be above a maximum reasonable level or otherwise unlawful."³⁶

The jurisdictional threshold and the revenue adequacy provisions thus allow the railroads to charge excessive monopoly rates for captive coal shippers, with little fear of regulatory intervention by the ICC. The threshold ratio also creates a pricing safe harbor for competitive shipping rates, which adds to the burden placed on captive shippers. The railroads can price competitive shipments at unreasonably low levels (even below cost) without fear of regulatory

³¹ *Statement of Fact and Argument of Western Railroads, Ex parte* No. 347 (Sub. No. 1), (I.C.C. April 13, 1982).

³² *Opening Statement*, No. 37038, at 11.

³³ 49 U.S.C. § 10704(a)(2) (Supp. IV 1980).

³⁴ *Aluminum Co. of Am. v. Bauxite & N. R.R. Co.*, No. 370815, slip. op. (I.C.C. Dec. 16, 1982).

³⁵ *Id.* at 5.

³⁶ *Id.* at 12.

scrutiny, because the rates will be below the jurisdictional threshold and outside ICC jurisdiction. Any losses incurred on these competitive shipments can be recovered by raising the rates for captive shippers up to or beyond the threshold ratio.

As long as the railroads remain "revenue inadequate,"³⁷ the ICC will be encouraged to allow rate increases for coal shippers beyond the threshold ratios, which will greatly facilitate predatory pricing and discriminatory underpricing.³⁸ These practices are likely to be employed by the railroads in an effort to maintain or increase their competitive market shares. According to the Subcommittee Report, the ICC allowed such practices prior to the Staggers Act: "The ICC has applied its interpretations of section 205 [of the 4-R Act] so that coal shippers subsidize noncoal traffic: The agency's theory is that coal revenue should subsidize a carrier's operations in competitive markets."³⁹

The Staggers Act makes it even easier for the railroads to recover competitive losses through their captive coal shipping rates, because of the safe harbor created by the jurisdictional threshold ratios. Although the Act includes perfunctory provisions to protect captive shippers against such unfair pricing schemes,⁴⁰ their effectiveness is destroyed by inappropriate cost standards, unreasonable evidentiary requirements for complainants, severe informational problems, and other obstacles to the detection and corroboration of underpricing or predatory pricing by the railroads.⁴¹

In sum, the jurisdictional threshold ratios place an enormous burden upon coal and other captive shippers. They largely remove protection from monop-

³⁷ In its *Railroad Revenue Adequacy 1981 Determination, Ex parte* No. 439, decided November 18, 1982, the ICC found that only two Class I Railroads, the Clinchfield and the Fort Worth and Denver, were revenue adequate under the financial criteria developed by the ICC.

³⁸ "Although there is some disagreement among scholars over semantics, predatory pricing is said to occur when a seller cuts price below the level of its rivals' costs and perhaps also its own costs for protracted periods, until the rivals either close down operations altogether or sell out on favorable terms." F. SCHERER, *INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE* 482 (2nd Ed. 1980). To avoid confusion over semantics, the separate term "discriminatory underpricing" is used here to describe situations where the obliteration of rivals is not intended, but the management of a partially regulated firm establishes prices below the level which is in the public interest.

³⁹ See *infra* notes 5-8 and accompanying text.

⁴⁰ The Staggers Act incorporated the following rail transportation policy in the Interstate Commerce Act: ". . . to prohibit predatory pricing and practices, to avoid undue concentrations of market power and to prohibit unlawful discrimination." 49 U.S.C. § 10101a(13). Perfunctory protection against predatory pricing and discrimination is provided by the "minimum rate provisions" included in Section 201(a) of the Act. 49 U.S.C. § 10701a (1982).

⁴¹ The Staggers Act is unclear about the requirements for the shipper's proof: "A rail carrier may meet its burden of proof . . . by establishing its variable costs in accordance with such section 10705a(m)(1), but a shipper may rebut that showing by evidence of such type, and in accordance with such burden of proof, as the Commission shall prescribe." 49 U.S.C. § 10709(d)(3) (1982).

The shippers must go through a painstaking and often fruitless discovery process in an effort to obtain pertinent cost information to calculate variable costs and develop their case. The ICC has observed: "Without some knowledge of the actual operations to be performed in providing the service, and the actual facilities to be used, the complainant may have no means of meeting this burden. The carrier defending the rate is generally the only source of this knowledge." 362 I.C.C. at 823.

oly prices and encourage the railroads to establish rates for captive shipments at excessive levels. These faults would be troublesome, even if the threshold ratios had been established at relatively low revenue-variable cost percentages. However, under those circumstances, the ICC could have retained jurisdiction over most coal shipping rates, and judged the reasonableness of the rates by considering all of the pertinent factors. In contrast, the exorbitant thresholds in the Staggers Act leave captive shippers virtually unprotected against monopoly abuses by the railroads.

By removing regulatory protection from excessive rates, the Staggers Act changes one of the fundamental "ground rules" of our economy: government protection from monopoly abuses by the railroads. This change in policy is particularly troubling, since much of the railroads' monopoly power has developed as a result of government land grants and years of government protection from the forces of competition. For nearly 100 years, the ICC has restricted entry into the transportation industry, allowing the railroads to strengthen their considerable monopoly power. Until the Staggers Act, this strategy was largely balanced by a policy of requiring fair and reasonable rates. With rate regulation, the ICC had the ability to protect shippers from the abuses of monopoly power created and strengthened by the government. Unreasonable discrimination, predatory pricing, and other monopolistic practices could be controlled. However, with passage of the Staggers Act, Congress has largely eliminated this protection, without diminishing the railroads' monopoly power.

This change of federal policy is even more indefensible, since many captive shippers served by the railroads have made long-term investments and other commitments based upon the presumption that the government would continue its historic policy of preventing price-gouging and unfair discrimination. For instance, many electric utilities have invested millions of dollars in coal-fired generating plants, and entered into long-term contracts for coal purchases that can be shipped only by railroad. It is confiscatory and unjust to change the rules after such large commitments have been made. Yet the Staggers Act permits this result.

VI. THE THRESHOLD RATIOS ENCOURAGE WASTE AND INEFFICIENCY

The problems inherent in the Staggers Act go beyond the inequitable treatment of captive shippers. Railroads are given excessive discretion to determine the extent of ICC jurisdiction over their rates and are rewarded for waste and inefficiency. Under conditions of pure competition, managers of a profit-maximizing firm will attempt to minimize variable costs. However, under the scheme of deregulation mandated by the Staggers Act, railroad managers have an incentive to inflate the variable costs for captive shipments, decrease their revenue-variable cost ratios to levels below the jurisdictional threshold, and circumvent ICC regulation.

Thus, the railroads have little motivation to minimize their operating costs for captive shipments. Under the Staggers Act, they can increase rates to 160 - 180 percent of variable costs without threat of regulatory intervention. The more the variable costs increase, the higher the allowed rate and the higher the

profit from captive shipments. Consequently, the threshold ratios not only remove the incentive for efficiency, but they create a perverse incentive for inefficiency and excessive costs. Every time a railroad succeeds in increasing its variable costs by 100 dollars, it can raise its rates by 160-180 dollars without ICC interference. In turn, this 100 dollars of additional cost yields an increase in gross profits of 60 to 80 dollars. The more inefficient and wasteful the railroad becomes, the less constrained it will be by regulation, and the more it will be able to achieve exorbitant profits. Under these conditions, even the most public-spirited management is likely to grow lackadaisical in its labor negotiations and other activities affecting variable costs. A sub-optimum approach is the best behavior that can be expected. The more likely result is even greater inefficiency and waste, as managers actively respond to the perverse incentive to increase the variable cost level.

This undesirable result contrasts sharply with the pressures encouraging efficiency which are present in other sectors of the economy. Under conditions of competition, an inefficient firm does not survive very long, because its costs soon exceed the market-determined prices for its products. Likewise, regulation normally creates an incentive to maintain efficient operations to the extent that regulated firms are not allowed to recover costs which result from management mistakes and inefficiencies. Under the Staggers Act, neither of these constraints is imposed upon railroads. Railroads enjoy extensive monopoly power along their captive shipping routes and are not constrained by the market in setting rates for these shipments. Moreover, by simply increasing costs and maintaining the revenue-variable cost ratios for these movements at the jurisdictional threshold ratios, the railroads can free themselves of the restraints which should be imposed by regulation.

VII. CONCLUSIONS

In its effort to reduce unnecessary and inefficient regulation of the railroads, Congress created a system which is fundamentally flawed. Under an arbitrary definition of jurisdictions, the railroads can exercise almost unlimited discretion in setting rates. Rates below the jurisdictional threshold ratio are beyond ICC jurisdiction while rates above the threshold, even excessive ones, can be justified as long as the railroads are labeled "revenue inadequate."

The Staggers Act prescribes the jurisdictional threshold as a test for market dominance; however, this revenue-variable cost ratio is nothing more than a random guide for reducing government regulation. Consequently, the Act removes regulatory protection from vital areas like captive coal shipments, where shippers are left to face unconstrained monopoly pricing by the railroads. This drastic change in regulatory policy is unjust, particularly since the railroads have gained much of their monopoly power from protective governmental policies. By eliminating that protection, the Staggers Act may cause severe economic disruptions with undesirable consequences. Moreover, the use of arbitrary revenue-variable cost ratios for defining ICC jurisdiction creates an incentive for inefficiency and excessive costs along captive shipping routes: by decreasing the ICC's jurisdiction as variable costs increase, they encourage the railroads to inflate their costs.

In sum, the Staggers Act which adversely affects coal shippers as well as other sectors of the economy, is an inappropriate mechanism for deregulating the railroad industry. Although the elimination of *unnecessary* regulation should be encouraged, the government should not abandon its responsibility to protect shippers in particular, and society in general, from abuses which prompted regulation of monopoly power almost a century ago.