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Daniel A. Crane
University of Michigan Law School, dancrane@umich.edu

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WERE STANDARD OIL'S REBATES AND DRAWBACKS COST JUSTIFIED?

DANIEL A. CRANE*

I. INTRODUCTION

Standard Oil's preferential railroad rebate structure lies at the heart of the seminal *Standard Oil* case, which culminated in the Supreme Court's 1911 affirmation that Standard Oil had violated the Sherman Act and should be broken up.[1] Beginning in 1868, Standard Oil received rebates of varying amounts from railroads for crude and refined oil shipped east over their lines. In some later years, it also received drawbacks for oil shipped by independent refiners—Standard Oil's competitors. The rebates and drawbacks gave Standard Oil a competitive advantage over their rivals and accounted for a large part of the reason that John D. Rockefeller obtained such dominance in oil refining and distribution.

The muckraking journalist Ida Tarbell made Standard Oil's discriminatory rebates a central feature of her crusade against the Rockefeller interests.[2] The government also made the rebates a central point of its case,[3] and the Supreme Court affirmed their illegality. Thereafter, the Interstate Commerce Commission effectively ended the legality of such rebates as a regulatory matter.

From the beginning, however, pro–Standard Oil voices have argued that, far from exhibiting a rapacious strategy to destroy rivals, the rebates and drawbacks were simply a reflection of Standard Oil's superior efficiency. In this story, Standard Oil was able to exact rebates and drawbacks from the railroads because it was able to pass along

* Professor of Law, University of Michigan.

1. Standard Oil Co. v. United States, 221 U.S. 1 (1911).

2. *See* IDA M. TARBELL, THE HISTORY OF THE STANDARD OIL COMPANY (1904).

3. *See Standard Oil*, 221 U.S. at 42 (describing government's charges of "[r]ebates, preferences, and other discriminatory practises [sic] in favor of the combination by railroad companies").

extraordinary efficiencies to the railroads. In short, the claim is that the rebates and drawbacks were cost justified. The cost justification claim has gained momentum in the past few decades, particularly with its adoption in Ron Chernow's 1998 bestselling biography of Rockefeller.[4]

In this essay, written for a symposium on the centennial anniversary of the Supreme Court's *Standard Oil* decision, I reexamine the cost-justification question. In the first part, I explain why the cost-justification question is central to the entire case and its acquired and evolving historical meaning. In the second part, I review the evidence of claimed efficiencies passed on to the railroads. I conclude that there is evidence that Standard Oil passed along significant cost savings to the railroads and that these savings could have justified a portion of the rebates and drawbacks. However, I conclude that there is little or no evidence that the rebates were proportional to the magnitude of the savings—which is the critical question. Moreover, elements in the structure and timing of the rebates and drawbacks seem more consistent with a story of exclusion than with cost justification.

II. WHY THE COST-JUSTIFICATION QUESTION MATTERS

The issue of the rebates' cost justification is foundational to a number of critical ways in which we think about the law and economics of the *Standard Oil* litigation.[5]

First, and most simply, the cost-justification question is important because the rebates and drawbacks are central to the narrative of the case. The rebates and drawbacks were allegedly a primary means by which Standard Oil acquired dominance over its rivals.[6] If the railroads granted the rebates and drawbacks simply as a concession reflecting the cost savings Standard Oil passed on to them, then it is difficult to understand why their receipt by Standard Oil should give rise to antitrust liability. Further, if the rebates and drawbacks were cost justified, their secrecy should not create any reason to consider them nefarious. There are many legitimate economic reasons for preserving secrecy about and within

4. *See* RON CHERNOW, TITAN: THE LIFE OF JOHN D. ROCKEFELLER, SR. (1998).

5. *See* D. Daniel Sokol, *The Strategic Use of Public and Private Litigation in Antitrust as Business Strategy*, 85 S. CAL. L. REV. 689, 707–20 (2012) (studying the private litigation against Standard Oil).

6. *See Standard Oil*, 221 U.S. at 42.

contracts.[7] This is particularly true of price-discriminatory contracts, whose revelation to other clients of the vendor could force the vendor to lower its prices to others and, over time, erode the entire price discrimination scheme.

Second, since the rebates were attacked as unlawful because they violated the railroads' common carrier obligations of nondiscrimination, it is useful to ponder whether they were cost justified. It was at least arguable that the late nineteenth-century common law permitted railroads to offer volume-based and cost-based discounts.[8] Further, it was generally unlawful at common law for a railroad to grant discriminatory rebates, but not for a shipper to receive them.[9] If the rebates were lawful at common law, then their use as a predicate act of exclusion for Sherman Act purposes is questionable. The framers of the Sherman Act insisted that, substantively, they were enacting the common law.[10] In early cases like *Trans-Missouri*,[11] the Supreme Court held that Sherman Act liability might attach even to agreements lawful at common law, but it later retreated somewhat and tried to harmonize its reading of the Sherman Act with the common law.[12] Indeed, the Supreme Court's *Standard Oil* decision was perhaps most notable—and controversial—for relying heavily on English and American common law and adopting the common law's rule of reason into Sherman Act jurisprudence.[13] The rebates' cost justification is thus significant in

7. *See generally* Omri Ben-Shahar & Lisa Bernstein, *The Secrecy Interest in Contract Law*, 109 YALE L.J. 1885 (2000) (arguing that revealing secret contract terms might weaken a party's bargaining position in future contract negotiations and also might allow other contracting parties that learn the previously secret information to hold up performance of existing contracts to demand new and more favorable terms).

8. AMBROSE PARÉ WINSTON, PUBLIC OPINION AND THE STANDARD OIL COMPANY 14–15 (1908).

9. Brief for Appellants, Vol. 1, at 201–02, Standard Oil Co. v. United States, 221 U.S. 1 (1911) (No. 398). Indeed, the Interstate Commerce Act generally did not impose liability on shippers that received discriminatory rates until the Elkins Act amendments in 1903. *See* CHERNOW, *supra* note 4, at 116.

10. *See* ROBERT H. BORK, THE ANTITRUST PARADOX: A POLICY AT WAR WITH ITSELF 20 (1978).

11. United States v. Trans-Missouri Freight Ass'n, 166 U.S. 290, 328 (1897) ("A contract may be in restraint of trade and still be valid at common law.").

12. *See, e.g.*, Addyston Pipe & Steel Co. v. United States, 175 U.S. 211, 237–38 (1899) (explaining that a contract held illegal under the Sherman Act would also have been illegal under common law). For a discussion of the rule of reason, see Andrew I. Gavil, *Moving Beyond Caricature and Characterization: The Modern Rule of Reason in Practice*, 85 S. CAL. L. REV. 733 (2012) (reviewing the history of the rule of reason since *Standard Oil*); Alan J. Meese, *Standard Oil as Lochner's Trojan Horse*, 85 S. CAL. L. REV. 783 (2012) (studying the constitutional origins of the rule of reason).

13. *See Standard Oil*, 221 U.S. at 50–51 (explaining importance of common law in interpreting the Sherman Act). On the controversy surrounding the Supreme Court's adoption of the common law's

understanding the degree to which the Supreme Court's Sherman Act jurisprudence departed from or remained faithful to the Sherman Act's common law moorings.

Third, the rebates and drawbacks are important predicate issues to the predatory-pricing issues and their subsequent legacy in controversy around predatory-pricing law.[14] Many of the accounting issues surrounding the predatory-pricing claims and the meaning of "cost" in the oil distribution context are affected by the inclusion or exclusion of Standard Oil's rebates from the cost calculus. For example, including the drawbacks on other firms' shipments as a legitimate reduction in Standard Oil's distribution cost, on the theory that the drawbacks were a remittance in consideration of Standard Oil's reduction of the railroad's costs, almost certainly means that most challenged sales were not below cost. On the other hand, if the drawbacks were illegitimate side payments in consideration of Standard Oil's role as cartel ringmaster, then they should not be allowed as reductions in Standard Oil's cost basis for purposes of analyzing the predatory-pricing claims.

Finally, if the rebates and drawbacks were cost justified, then there is less reason to look for nefarious reasons—literally, conspiracy theories—that the railroads would have extended such significant price cuts. Ida Tarbell asserted, with scant support, that Standard Oil "bribed" railroad executives into giving rebates.[15] With much greater support, Elizabeth Granitz and Ben Klein have argued that Standard Oil was able to monopolize petroleum distribution by serving as a cartel ringmaster for the three principal railways and collusively stabilizing the railways' market shares by shifting its shipments between lines to maintain the agreed-upon market shares.[16]

If, however, the rebates and drawbacks were cost justified, conspiracy

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rule of reason in *Standard Oil*, see WILLIAM LETWIN, LAW AND ECONOMIC POLICY IN AMERICA: THE EVOLUTION OF THE SHERMAN ANTITRUST ACT 265–70 (1965).

14. *See generally* Christopher R. Leslie, *Revisiting the Revisionist History of* Standard Oil, 85 S. CAL. L. REV. 573 (2012).

15. TARBELL, *supra* note 2, at 227 ("It was to get rid of competition that the oil-carrying railroads were bullied or persuaded or bribed into unjust discrimination."). For further discussion of the ringmaster theory, see Benjamin Klein, *The "Hub-and-Spoke" Conspiracy that Created the Standard Oil Monopoly*, 85 S. CAL. L. REV. 459 (2012); George L. Priest, *Rethinking the Economic Basis of the Standard Oil Refining Monopoly: Dominance Against Competing Cartels*, 85 S. CAL. L. REV. 499 (2012).

16. Elizabeth Granitz & Benjamin Klein, *Monopolization by "Raising Rivals' Costs": The Standard Oil Case*, 39 J.L. & ECON. 1, 1 (1996).

theories become less necessary to the story. A *New York Times* editorial from August 11, 1906, asks:

> Can it be possible that the Standard Oil had something to give for the rebate, and that this explains why the rebate was given to Standard Oil instead of to its competitors, who had not the inducement to offer in the way of volume of traffic in exchange for the rebate which induced the shipper to route his traffic in the manner profitable to both parties to the transaction? This idea of mutuality in the transaction is slow in making its way into the public mind, but it is important to an appreciation of the nature of the act. The idea that the railways rebated just as burglars steal, from pure criminality and without the element of an exchange of equivalents, should be abandoned.[17]

Moreover, under simple economic assumptions, Standard Oil, as a customer of the railroads, should have preferred competition among the railroads to collusion, and the railroads, as Standard Oil's suppliers, should have preferred not to deal with a monopsony customer. But each side might have tolerated, indeed enabled, the other side's acquisition of market power given an acceptable quid pro quo. The cost-justification question thus lies at the center of the broader question of whether we should regard the Standard Oil episode as an instance of unilateral exclusionary conduct or a complex web of conspiracies to monopolize and cartelize a number of vertically related economic activities.[18]

III. WERE THEY COST JUSTIFIED?

A. REBATES

The cost-justification theory was asserted early in the academic skirmishing over the *Standard Oil* case. While the prosecution was still ongoing, Ambrose Winston wrote a tract in which he argued that the railroads gave rebates for essentially two reasons.[19] First, Standard Oil made oil shipments that were both more regular and in considerably higher volumes than other oil companies.[20] This increased regularity and volume supposedly created huge savings for the railroads. Winston cited an example of the Lake Shore Railroad whose executives claimed that, prior to their deal with Standard Oil, the average time for a freight car round trip from Cleveland to New York was thirty days, but if the railroad could

17. *The Standard Oil Rebates*, N.Y. TIMES, Aug. 11, 1906.

18. *See generally* Barak Orbach & Grace Campbell Rebling, *The Antitrust Curse of Bigness*, 85 S. CAL. L. REV. 605 (2012) (discussing the size obsession in antitrust tradition).

19. WINSTON, *supra* note 8, at 12.

20. *Id.*

secure sixty oil cars per day it could reduce the round trip to ten days by moving in solid trains instead of mixing oil cars in other trains.[21] This would supposedly reduce the railroad company's investment from $900,000 to $300,000.[22]

Second, Winston claimed that Standard Oil saved the railroads money by taking over functions previously performed by the railroads. In some cases, Standard Oil contractually relieved the railroads of all risk of liability for fires or other accidents.[23] In other cases, Standard Oil furnished its own tank cars, stations, and switches, and took over all of the loading and unloading functions.[24] Winston concluded that "the low rate in these cases is due to services performed by Standard Oil (loading, etc.) not ordinarily performed by shippers."[25]

In his biography of John D. Rockefeller, Ron Chernow extended Winston's cost-justification claims. According to Chernow, Rockefeller and Henry Flagler "didn't simply try to squeeze the railroads—they were much too shrewd and subtle for that—but offered compelling incentives."[26] In addition to assuming liability for accidents, Standard Oil committed to Lake Shore to stop using water transport during summer months.[27] In addition, Rockefeller and Flagler committed to ship sixty carloads of refined oil a day. Since Standard Oil lacked that capacity on its own, it coordinated with other Cleveland refiners to secure the sixty carloads.[28] Further, "Rockefeller's firm invested heavily in warehouses, terminals, loading platforms, and other railroad facilities so that the railroads probably derived more profit from his shipments than from those of rivals who paid higher rates."[29] For Chernow, the Lake Shore deal showed the benefits to the railroads of dealing with a monopsony customer: "From [the moment of the Lake Shore deal], the railroads acquired a vested interest in the creation of a gigantic oil monopoly that would lower their costs, boost their profits, and generally simplify their lives."[30]

Although it seems clear that the rebates reflected some cost savings to

21. *Id.*
22. *Id.*
23. *Id.*
24. *Id.* at 12–13.
25. WINSTON, *supra* note 8, at 13.
26. CHERNOW, *supra* note 4, at 113.
27. *Id.*
28. *Id.*
29. *Id.* at 116.
30. *Id.* at 113.

the railroads, the historical record does not support a conclusion that they were fully cost justified. A variety of factors call the cost-justification story into doubt.

First, none of the advocates of the cost-justification position have attempted to show that the rebates were proportionate to the railroads' cost savings. Although one need not—and should not—demand the stringency of modern, forensic-accounting-intensive Robinson-Patman Act cost justification,[31] proof that Standard Oil saved the railroads *some* money is surely insufficient to prove that the rebates were cost justified. At a minimum, the historical record is devoid of evidence tending to show that the rebates were structured proportionately to any cost savings, and this leaves open the possibility that some portion of the rebates and drawbacks were compensation to Standard Oil for performing the cartel ringmaster function.

Second, Standard Oil's own briefs did not pursue a cost-justification argument. As set forth above, such an argument would likely have been available to Standard Oil to the extent that it pursued a common law justification for its conduct—a tactic that Standard Oil did pursue on other issues. But instead of showing that the rebates were cost justified, Standard Oil largely focused on proving that the rebates were unexceptionable and not illegal prior to the passage of the Hepburn amendments to the Interstate Commerce Act in 1906.[32] Thus, for example, Standard Oil emphasized the indubitable fact that freight "schedule rates were merely nominal" and that no one paid full price.[33] Standard repeatedly stressed that its rivals were offered the same deals that Standard was offered.[34] Although that argument may help to show the absence of discrimination, it tends to undermine any efficiency arguments, since it concedes that Standard Oil was not exceptionally situated.

Third, as Granitz and Klein have argued, "If Standard's rate advantage was purely cost based, Rockefeller would not have had actively to prevent the railroads from offering discounts from agreed-upon railroad rates to independent refiners."[35] Even if Standard Oil was initially able to secure its

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31. *See* Daniel A. Crane, *Mixed Bundling, Profit Sacrifice, and Consumer Welfare*, 55 EMORY L.J. 423, 469–70 (2006) (explaining that courts have required stringent evidence of proportionality between savings and discounts in order to establish cost justification defense under Robinson-Patman Act); HERBERT HOVENKAMP, ECONOMICS AND FEDERAL ANTITRUST LAW 347 (1985) (explaining that the cost-justification defense "has been so narrowly construed that it is almost impossible to use").

32. *See* Anti-Pass Acts, 34 Stat. 584 (1906).

33. Brief for Appellants, *supra* note 9, Vol. II, at 56.

34. *Id.*

35. Granitz & Klein, *supra* note 16, at 41.

rebates through superior efficiency, it labored hard to ensure that its rivals could not enjoy similar prices even if they were able to achieve similar level of efficiency.

Finally, the most dramatic effect of the rebate and drawback agreements came from rebates and drawbacks that were never actually implemented: those organized under the South Improvement Contract in 1871–1872. South Improvement was a venture of the major railroads to offer extraordinary price concessions to one major refiner in each of the four major refining centers. To illustrate, from a nominal price of $2.00 per barrel, each South Improvement refiner was to receive a rebate of $0.50 on its own oil shipments and an additional equal rebate on any oil shipped by an independent refiner. In return, each refiner would agree to act as an "evener" for the railroads, allocating its shipments among the railroads in proportion to the railroads' mutually agreed market share formula.[36]

In its defense, Standard Oil asserted that such allocation agreements were quite burdensome, since they required Standard Oil to shift its distribution routes to accommodate the railroads' allocation scheme rather than Standard Oil's own preferences. Rockefeller testified, for example, that the allocation agreements often required Standard Oil to ship oil to Philadelphia when it would have preferred to ship to New York.[37]

But if the allocation schemes were a net burden to Standard Oil, it is difficult to understand their effect on Standard Oil's Cleveland refiner rivals, which quickly began to sell out to Standard Oil once the South Improvement scheme became known.[38] Standard Oil's protests on this score seem weak. First, it protested that the South Improvement scheme never went into effect and therefore could not have driven the refiners out of the market.[39] Second, it protested that the timing of events disproves the notion that the South Improvement deal caused the independents to sell out to Standard Oil, noting that "[t]he purchase of some of these, and negotiations for the purchase of others, took place in the last part of 1871 [whereas] [i]t was not until January 18, 1872, that the South Improvement Contract was signed."[40]

36. *Id.* at 9.

37. Brief for Appellants, *supra* note 9, Vol. II, at 53.

38. *Standard Oil*, 221 U.S. at 32 (reporting that in the 1871 to 1872 timeframe, Standard Oil "acquired substantially all but three or four of the thirty-five or forty oil refineries located in Cleveland, Ohio").

39. Brief for Appellants, *supra* note 9, Vol. II, at 44.

40. *Id.*

The flaw in this these arguments is that Rockefeller did not need to have operational contracts, or even consummated contracts, to convince the independents that they were about to be crushed by a rebate-and-drawback scheme that they could not possibly match. Although the South Improvement contract was not signed until 1872, all of the business terms had been finalized in late 1871.[41] Rumor of the impending South Improvement deal preceded its execution, and its devastating effect on independents' morale and business prospects was complete before the Oil War in March 1872 led to the demise of the South Improvement scheme.

We are left, then, with the fact that the independents in Cleveland realized their doom upon learning of the rebate-and-drawback scheme: they realized that no matter how hard they tried to realize their own efficiencies, they would not be able to match Standard Oil's distribution costs. This alone does not disprove the cost-justification account, since it is possible that the South Improvement deal was simply the final piece of evidence of Standard Oil's superior efficiency necessary to convince the independents that they could not compete with Rockefeller's superior mousetrap. However, that possibility seems to be undermined by the fact that Rockefeller touted the fact of the rebate-and-drawback provisions, rather than his own superior efficiency, as the reason that the independents should sell out.[42] Since the refiners were in the same business and the same geographic market as Rockefeller, they did not need the railroads' affirmation of Standard Oil's superior efficiency to believe that they could no longer compete. That Rockefeller used the fact of his contractual triumph with the railroads as leverage in twisting the independents' arms undermines the cost-justification account.

B. DRAWBACKS

Acknowledging that drawbacks "seem to be a different story" from rebates, Michael Reksulak and William Shughart nonetheless justify the drawbacks as pass-ons of cost savings generated by Standard Oil's superior efficiency.[43] First, "by helping to reduce the average cost of rail transportation . . . , Rockefeller conferred a positive externality on his rivals, reducing the railroads' average cost of handling their shipments as well. Drawbacks were a way for the railroads to share those gains with the

41. Granitz & Klein, *supra* note 16, at 14.

42. *Id.* at 15.

43. Michael Reksulak & William F. Shughart II, *Of Rebates and Drawbacks: The Standard Oil (N.J.) Company and the Railroads*, 38 REV. IND. ORGAN, 267, 280–81 (2011).

company that was responsible for them."[44] Second, Reksulak and Shughart hypothesize that the drawbacks were a means of preventing competitors from using Standard Oil's secret prices as bargaining leverage with the railroads:

> [G]iven that it was common practice for all shippers to exploit a rebate that had been granted by one railroad to 'shop around' for an even larger discount off the published tariff from another, drawbacks plausibly also had the advantage of being more difficult for competitors to discover and use as bargaining leverage.[45]

As with the rebates, it is plausible that the drawbacks reflected some efficiency advantage. However, the claim that the drawbacks were merely a pro rata recoupment by Standard Oil of the efficiency benefits it passed onto the railroads is questionable, at best. Something other than efficiency seems necessary to account for the drawbacks' structure.

In assessing the efficiency defense as to the drawbacks, it is useful to break down the kinds of efficiencies Standard Oil may have passed on to the railroads into two pools—volume-based efficiencies and service-based efficiencies. Volume-based efficiencies would be those arising from Standard Oil guaranteeing the railroads a large volume of oil shipments. Such efficiencies would not reduce the railroads' fixed or variable costs but would allow them to defray their fixed costs—largely, the costs of laying trackage—across a greater revenue base. Service-based efficiencies would be those arising from Standard Oil undertaking various transportation functions or costs—such as insurance and warehousing—that the railroads would otherwise have had to undertake or incur themselves. These services would largely reduce the railroads' marginal costs of transportation, although they could also reduce fixed costs by obviating the need for the railroads to invest in terminal infrastructure.

It seems unlikely that volume-based efficiencies can explain the drawbacks. As noted above, Standard Oil began to secure rebates and drawbacks years before it had sufficient volume on its own to justify them and had to consolidate shipments with other refiners in order to meet its guaranteed volumes. Its much-vaunted guarantee to Lake Shore of sixty carloads a day was only secured by coordinating volume among Standard Oil shipments and oil from other Cleveland refiners. Standard Oil may deserve some credit for organizing the guarantees, but cannot claim full

44. *Id.* at 280.
45. *Id.*

credit for the volume because much of it was supplied by others. Once Standard Oil had bought out most of its rival Cleveland refiners in 1872, it of course could guarantee the railroads much larger and more stable volumes. In light of the fact that it used its South Improvement rates as leverage to buy out its rivals, though, it hardly seems appropriate to credit its post-1872 volume as evidence of volume-based efficiencies as reasons for Standard Oil's drawbacks.

In trying to assess the economic functions of the drawbacks, Standard Oil itself gives us relatively little aid. In its briefs, Standard Oil spent far more time denying that drawbacks were given or that they were Standard Oil's fault than justifying their existence. Thus, for example, Standard Oil's Supreme Court brief emphasizes that the South Improvement contract was not Standard Oil's idea, that Rockefeller actively disapproved of it and only agreed to sign up under compulsion, and that it never went into effect.[46] As to evidence that some of the freight paid by West & Sons had found its way into Standard Oil's coffers, Standard Oil dismissed the evidence as hearsay and argued that it "should be barred as a narrative of past facts made after the alleged conspiracy had come to an end."[47]

Nowhere does Standard Oil embrace the possibility that its drawbacks were justified by its superior volume, which reduced the average cost of transporting its rivals' oil. Instead, where the company admitted to the existence of drawbacks, it sought to justify them as service based. Alas, the narrative here seems suspect as well.

In its briefs, Standard Oil acknowledged that it received some drawbacks—or, at least what others referred to as drawbacks. It nonetheless sought to justify these as fees paid by the railroads for a warehousing service. Thus, Rockefeller testified: "We were handling these large quantities of oil. *We were warehousemen.* We were natural parties to take these warehouses and handle them. It was in our regular business of the receiving and shipping of the oil . . . . *That was a special sort of a service, for which we were eminently fitted.*"[48] If Standard Oil was providing a warehousing service for its competitors' oil, it was only natural that it should be paid for the service.

46. Brief for Appellants, *supra* note 9, Vol. II, at 43 (asserting that none of the promoters of South Improvement "were connected with the Standard Oil Co."); *id.* at 44 (asserting that "Mr. Rockefeller and his friends did not believe in the [South Improvement] plan, but were unwilling to antagonize its promoters, especially Mr. Scott of the Pennsylvania, who was then potent in railroad circles"); *id.* (asserting that "[n]o oil was ever hauled under the contract").

47. *Id.* at 58.

48. *Id.* at 47.

However, if Standard Oil was providing its competitors a warehousing service, then why did its fee come through a secret rebate from the railroads rather than a direct charge to the firm offered the service? The answer implicitly given by Standard was that it was customary for the railroad to provide warehousing services and to incorporate those charges as part of its freight bill. Ordinarily, the fee for warehousing would be buried within the freight rate. But, occasionally, a railroad investing in new warehouse infrastructure would exact an itemized warehousing surcharge. Standard provided the example of the Erie Railroad, which, during a period of intensive investment in warehouse infrastructure and simultaneous fierce competition on freight rates, enacted a five-cent surcharge on every barrel of oil passing through its yards to cover warehousing expenses.[49]

Standard Oil then contrasted the Erie situation with that of New York Central, which "owned no terminals for receiving oils, and these were furnished by [Standard Oil], which had to be reimbursed, not merely for its services as warehouseman, but for the use of its premises."[50] Hence, explained Standard Oil, it was natural and logical for Standard Oil to charge New York Central a fee for its warehousing of independent refiners' oil. The railroad was to remit eighteen cents a barrel expressly for warehousing services—the marginal costs of processing the independents' oil. It was also to remit ten percent of the rivals' freight.[51] This, Standard Oil explained, reflected Standard Oil's investment in "real estate and equipment," effectively its recoupment of a portion of its fixed cost infrastructure enjoyed by the independents when they accessed Standard Oil's warehouses.[52]

While it is plausible that some portion of the drawback was meant to cover Standard Oil's warehousing expenses, there are two incongruities in the story that raise doubts as to whether the New York Central drawback was simply the remittance of an expense covered by Standard Oil. First, observe that the service or marginal cost component was set at a fixed rate—eighteen cents a barrel. But the fixed-cost component—what Standard Oil described as its recoupment of its sunk investment in real estate and equipment—was paid back as a percentage of the freight rate. This second portion of the drawback was thus invariant to the degree to which the shipper took advantage of Standard Oil's warehouses. A longer

49. *Id.* at 46.
50. *Id.* (emphasis omitted).
51. *Id.*
52. *Id.*

journey would presumably yield a higher remittance to Standard Oil than a shorter journey, but the length of the journey after leaving or coming to the warehouse would bear no relation to the amount of Standard Oil warehouse infrastructure "consumed." For example, if an independent's oil traveled 400 miles on the railroad's tracks and stayed in the warehouse for one day, Standard Oil would be owed a higher remittance than if it traveled 300 miles but stayed in the warehouse for two days, even though there would be more utilization of Standard Oil's infrastructure in the second case. Standard Oil was thus metering its warehousing infrastructure recoupment fee on a factor that bore little relation to the amount of warehousing resources the independent consumed.

This would not be particularly troubling if Standard Oil had become the railroads' joint-venture partner in operating a transportation service and thus expected to share in risks and rewards. But a second element of the New York Central arrangement calls a risk-and-profit-sharing joint venture into doubt. The ten percent "royalty" remitted to Standard Oil was not based on the freight rate paid by the independent but on the rate charged by New York Central to Standard Oil for shipment over the same line.[53] That rate was apparently the nominal rate (i.e., the rate before the payments of any rebates), which was generally above the market rate. The effect of this rebate structure was to ensure that Standard Oil received a generous slice of the independents' freight and to discourage the railroad from offering independents secret discounts, which would simply have increased the percentage of the independents' shipping charges recouped by Standard Oil.

In light of these facts, it seems that the drawbacks may have served two functions. As with the rebates, a portion of the drawbacks may have served to compensate Standard Oil for legitimately provided services. At the same time, the drawback structure suggests that Standard Oil may have used its role as a warehouseman as a pretext for imposing on its rivals a hidden tax that would ensure that they could never match Standard Oil's distribution costs. In that case, the drawbacks story would illustrate the raising-rivals'-costs story now familiar in the economic literature.

IV. CONCLUSION

As best as one can tell from a fairly causal inspection conducted well over a century after most of the relevant events transpired, the answer to

53. *Id.* (explaining that the remitted sum "should be equal to 10 per cent of the freight due the railroad from the Standard Oil Co. upon oil transported for it over said railroad").

the question, "Were Standard Oil's rebates and drawbacks cost justified?" is both yes and no. Yes, Standard Oil created efficiencies for the railroads for which it deserved a reduction in rates and, to some extent, compensation drawn from its rivals' rates. But, no, cost justification falls short as a complete explanation for the rebates and drawbacks. On balance, the need to find some additional—and likely nefarious—explanation seems compelling.

This is not necessarily to say that the courts were right to condemn the rebates and drawbacks, that the muckrakers' shrill attacks on any form of secret rebating are well taken, or that the Interstate Commerce Commission's eventual insistence on strict rate equality was desirable. Joseph Schumpeter may have been correct in describing Rockefeller's rebates and other aggressive dealings as necessary to sweep away the conventional property rights standing in the path of capitalism's gales of creative destruction.[54] Standard Oil may have won a good deal of the battle through superior efficiency in a variety of ways, and society may have been better off because of it. But pure cost justification does not provide a complete or convincing account for the rebates and drawbacks.

54. JOSEPH A. SCHUMPETER, CAPITALISM, SOCIALISM, AND DEMOCRACY 89 (1942) ("Even the conquest of financial control over competing concerns in otherwise unassailable positions or the securing of advantages that run counter to the public's sense of fair play—railroad rebates—move, as far as long-run effects on total output alone are envisaged, into a different light; they *may* be methods for removing obstacles that the institution of private property puts in the path of progress.").