MERCATUS CENTER
George Mason University

RESEARCH SUMMARY

The Case for Continued Light-Touch Regulation of Freight Railroads

Railroads play an important role in the US freight transportation system. But most markets are connected by no more than two railroads and some only by one. Changes in government policy could promote competition between railroads without interfering with their ability to earn enough profits to invest and improve service.

In the July 2021 Executive Order on Competition in the American Economy, the Biden administration suggested that the Surface Transportation Board (STB) introduce new freight rail regulations—namely, reciprocal switching and final offer rate review (FORR)—to help shippers facing rising rail carrier rates. In "The Case for Continued Light-Touch Regulation of Freight Railroads," Tracy C. Miller considers these suggestions in the context of the historical and existing US rail regulations, then analyzes their likely effects on the industry. He finds that reciprocal switching may negatively affect rail carrier incentives while doing little to increase competition, and that, although final offer arbitration is more promising than FORR, the latter could be used as a last resort measure for small shippers facing exorbitant rates.

HISTORICAL BACKGROUND: THE DANGERS OF OVERREGULATING FREIGHT RAIL CARRIERS

The Interstate Commerce Act of 1887 introduced the Interstate Commerce Commission (ICC), the original railroad regulator in the United States. The ICC "rate bureaus" determined what railroads could charge and subjected contracts between rail carriers and shippers to regulatory oversight. With increasing competition from other modes of freight shipping, notably trucking, ICC regulation hampered railroads' ability to enter and exit markets or adjust prices.

The rise in railroad bankruptcies demonstrated the need for deregulation, such as the Railroad Revitalization and Regulatory Reform Act of 1976 and the Staggers Rail Act of 1980. These reforms allowed railroads the flexibility to divest themselves of unprofitable routes and respond to market signals. As a consequence, investment in railroads increased. Between 1981 and 2001, logistics costs fell from 16 percent to less than 10 percent of GDP. Although railroad rates have risen since 2004, they are, on average, about 33 percent lower now than in 1980.

EXISTING FREIGHT RAIL REGULATION

The STB, which replaced the ICC in 1996, is tasked with protecting shippers from "excessive" rates while also ensuring that railroads earn "adequate revenues." Under the current system, railroads are free to set rates as they wish, but the STB can review their "common carrier rates" if a shipper challenges them. However, it is costly to prove that rates are excessive. As a result, it is mainly the large shippers that bring such challenges, leaving small "captive" shippers without relief.

CONTINUING LIGHT-TOUCH REGULATION WITH MARGINAL CHANGES

To improve options for shippers, the Biden administration's executive order proposes reciprocal switching and FORR.

1. Reciprocal switching mandates carriers to stop at an interchange point and unload their cargo onto a competing rail carrier. This is intended to enhance options for shippers that have access to only a single rail carrier. However, first, it is unclear whether the carrier on the other side of the interchange point would have the incentive to significantly reduce rates. Second, it would add significant switching costs to rail carriers on covered routes and negatively affect investment. Reciprocal switching would also increase delivery times, sometimes substantially, resulting in loss of efficiency that ultimately undermines the bottom line of both shippers and recipients of the cargo.

2. Under FORR, the STB would review offers from shippers and carriers and select the one that it deems to be fairer. However, final offer arbitration may be a better solution than FORR. It offers shippers the ability to challenge rates in a low-cost manner with voluntary cooperation from rail carriers. FORR could be maintained as a backstop for carriers that do not consent to arbitration.

KEY TAKEAWAY

The current light-touch approach to freight rail regulation has improved the financial viability and increased the efficiency of railroads. Marginal adjustments may help improve the situation for small shippers, but agencies should not implement rules that would significantly affect the railroads' incentives to invest and improve their services, as happened under the ICC regulation in the twentieth century.