

BEFORE THE
SURFACE TRANSPORTATION BOARD

STB EX PARTE NO. 627
MARKET DOMINANCE DETERMINATIONS –
PRODUCT AND GEOGRAPHIC COMPETITION

COMMENTS OF THE
UNITED STATES DEPARTMENT OF AGRICULTURE

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Date: May 29, 1998

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AUTHORITY AND INTEREST

Pursuant to its decision in Review of Rail Access and Competition Issues, STB Ex Parte 575, served April 17, 1998, the Surface Transportation Board (Board) has instituted this proceeding to consider removing product and geographic competition as factors in market dominance determinations in railroad rate proceedings. USDA believes that product and geographic competition should be removed as factors considered in market dominance determinations.

These comments are filed on behalf of the Secretary of Agriculture. The Secretary is charged with the responsibility under the Agricultural Adjustment Act of 1938 and the Agricultural Marketing Act of 1946 to represent the interests of agricultural shippers and

producers in improving transportation services and facilities by, among other things, initiating and participating in Board proceedings involving rates, charges, tariffs, practices, and services.

PREFATORY REMARKS

Farmers are dispersed over the entire country. Unlike the situation in many other industries, agricultural producers are unable to move their operations to other locations – indeed, their operations are tied to the land and often to a particular climate. Rail and barge transportation are the only cost effective modes of transportation for those agricultural commodities produced far from domestic or export markets. To compete effectively in increasingly competitive world markets, American farmers must have access to efficient, reliable and cost-competitive transportation. The rates agricultural producers pay for rail transportation must be at a level which will preserve American competitiveness in world agricultural markets while adequately compensating those transporting agricultural commodities.

FAILURE OF THE CURRENT MARKET DOMINANCE TESTS

Since the Interstate Commerce Commission replaced the four tests¹ used to determine market dominance with the current evidentiary guidelines, there have been virtually no regulatory constraints on rates charged to captive shippers. Current market dominance guidelines make it too expensive, time consuming, and risky for most agricultural shippers to refute the effectiveness

¹ These four tests were a revenue-to-variable cost test, market share test, the presence of substantial investment or long-term contracts, and whether the rate had been set by a rate bureau.

of product and geographic competition.² Since, under current law, market dominance must first be shown before the Board will open a rate reasonableness proceeding, it is important that the Board remove unnecessary obstacles to the proof of market dominance.³ The Department of Agriculture commends the Board for its willingness to reevaluate the use of product and geographic competition in making market dominance determinations.

The procedures to determine market dominance need to be greatly simplified, particularly so that effective protection against unreasonable rates is afforded even to those smaller shippers without the monetary and legal resources to challenge large railroads. The Department of Agriculture encourages the Board to reduce its charges for filing rate reasonableness cases so that smaller shippers are not precluded from challenging rail rates.

Indeed, one of the major goals of the Staggers Act was to maintain reasonable rates where there is an absence of effective competition.⁴ Due to the financial condition of the rail industry during the 1970s and early 1980s, the goal of revenue adequacy for the carriers was given priority over the other goals of the Staggers Act. Currently, the large premiums being paid over book value when railroad firms merge and the large investments being made in infrastructure demonstrate that the railroad industry has regained financial health.

² 49 § U.S.C. 10707 requires only that intramodal and intermodal competition be considered. The Interstate Commerce Commission had initially concluded that consideration of product and geographic competition would complicate rate proceedings unduly.

³ Once market dominance is shown to exist, and if the revenue-to-variable cost ratio exceeds 180 percent, the Board then considers the revenue adequacy of the railroad before it rules on the reasonableness of a rate.

⁴ 49 § U.S.C. 10101 (6).

Agricultural shippers and farmers have made large investments based on the expectation of railroad service levels and price. Inadequate service levels and higher rail tariffs undermine the viability of those investments and result in a deterioration of the market values of shipper assets. Since the Staggers Act specifically lists protection of captive shippers as one of its major goals, it is only right for the Board to reemphasize the goal of providing rate and service protection to captive shippers.

GEOGRAPHIC AND PRODUCT COMPETITION

Although the Department of Agriculture recognizes that geographic and product competition can limit railroad pricing in some cases, we believe that these forms of competition are less relevant to market dominance today in light of the rapid consolidation of the rail industry. This railroad consolidation has created many more captive shippers and has resulted in an increase in the market power of railroads relative to shippers. Of the crop reporting districts (CRDs) in the top twenty grain producing states, 87 CRDs were served by fewer than three railroads in 1996. Of these 87 CRDs, only 58 were served by fewer than three railroads in 1992. Thus 29 CRDs lost competitive choices between 1992 and 1996.

In 1980, the ability of a farmer to haul grain to an elevator served by a competing railroad often provided the competition necessary to constrain rail rates. Today, since only two Class I railroads serve the western United States, and many of the short line railroads are either physically or contractually tied to only one Class I railroad, most farmers no longer have a cost-effective option of hauling grain to an elevator served by a competing railroad. This decrease in intramodal

competition has also decreased the effectiveness and the relevance of geographic and product competition as a potential limit to railroad market power.⁵

Allowing railroads to exploit their dominance over domestic shippers is contrary to the principles of the Staggers Act which justified the deregulation of rail rates by the presence of effective competition. Deregulation of rates based on the assumption of product and geographic competition misses the point that unreasonable rates are more likely to be related to the existence of market dominance by the carrier than to the lack of product and geographic competition.⁵ Thus, by allowing the assertion of product and geographic competition in market dominance tests, major classes of shippers have been effectively eviscerated of Staggers Act protections.

In the past, railroads have argued that a railroad would be motivated to set a competitive rate without regulation because it could not afford to price its shippers out of the markets in which they compete. Due to the consolidation of railroads, these constraints upon a railroad's ability to set unreasonable rates do not prevent railroads from extracting the economic profits which are due to the efforts and innovations of shippers.⁷ The current market dominance tests using geographic and product competition fail to recognize this fact. Thus, railroads have been allowed to use their market power to charge captive shippers a rate which allows shippers to

⁵ Geographic competition is defined as the ability to ship a commodity to, or receive it from, another location via other railroads. Product competition is defined as the ability of the shipper to use a suitable substitute product that can be acquired without relying on the services of that railroad.

⁶ William B. Tye, *The Transition to Deregulation*, Quorum Books, Westport, CT, 1991, p. 158.

⁷ Rail rates resemble Ramsey pricing which is based upon the market power of the firm. Ramsey prices are calculated according to the inverse elasticity rule. As the price elasticity of demand for a product decreases, the price for that product increases.

recover only their variable costs but not the bulk of their fixed costs. This results in railroads extracting profits that rightfully belong to shippers.

Indeed, the ability of merged railroads to abrogate shipper contracts allows them to capture even the profits from long-lived shipper investments which have been made in the past. Once a shipper has made an investment, it becomes a fixed cost which the shipper needs to recapture, but is unable to do so when the railroads use their market power to charge unjustifiably high rates. The railroad will usually set its rates so as to allow the shipper to extract only a small amortization of the longer-run fixed costs.

Even if these problems did not exist, the concepts of geographic and product competition have several major problems. One of these is the definition of the relevant market. Railroads define the relevant market as the world market, claiming that if the price of a commodity is too high, the customer can obtain that commodity from other sources. But the fact that a shipper's customers have an alternative to buying from that shipper does not change the fact that the shipper has no alternative to dealing with the railroad. In other words, downstream competition in the product market does not translate to competition in the upstream market for transportation services.⁸ Thus, the lack of shipping alternatives, at either the origin or the destination, effectively removes the constraints of geographic and product competition upon the railroad's pricing. Since the final customer does not pay the additional shipping costs due to competitive alternatives, the captive shipper must absorb these costs. Thus, shippers define the relevant market as the transportation of the shipper's product between the two points involved in the move.

⁸ William B. Tye, *The Transition to Deregulation*, p. 159-60.

The Department of Agriculture supports the removal of product and geographic competition from the market dominance test used by the Board. In addition, the Department of Agriculture supports legislative remedies either to greatly simplify market dominance determinations or to remove them entirely from rate reasonableness challenges. The revenue-to-variable cost ratio and evidence of effective intramodal competition or intermodal competition, as envisioned by the authors of the Staggers Act in 49 § U.S.C. 10707, should in themselves provide an adequate indication of the presence of market dominance.

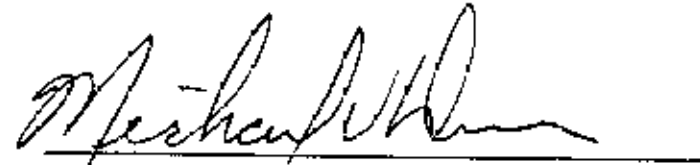
CONCLUDING REMARKS

The Department of Agriculture commends the Board for its review of product and geographical competition as factors in market dominance determinations in railroad rate proceedings. As shown by our presentation, allowing the assertion of product and geographic competition has in effect deprived captive shippers of the statutory protections against unreasonable rates which are included in the Staggers Act.

In summary, the Department of Agriculture requests that the Board:

- Reduce its charges for filing rate reasonableness cases to accommodate rate reasonableness challenges from smaller shippers.
- Remove product and geographic competition from the market dominance test.
- Support legislative efforts to greatly simplify the remaining procedures to determine market dominance or support the removal of the need to prove market dominance in rate reasonableness cases.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Michael V. Dunn", written over a horizontal line.

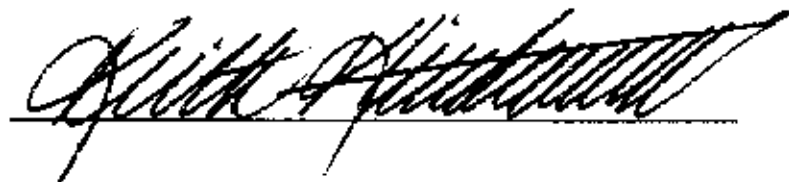
Michael V. Dunn
Assistant Secretary

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CERTIFICATE OF SERVICE

The undersigned hereby certifies that on May 29, 1998, he caused a copy of the Department of Agriculture's comments to be served by first-class mail, postage prepaid, on all parties of record in STB Ex Parte No. 627, Market Dominance Determinations--Product and Geographic Competition.



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