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Canada-United States Railway Economic Regulation Comparison

Research conducted for the Canada Transportation Act Review

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1.0 Introduction

The essential repository of Canadian and United States statutory law respecting the economic regulation of railways is to be found in two statutes and the statutory instruments promulgated under them: the *Canada Transportation Act*, S.C. C-10.4 (1996, c.10), as amended, ("CTA") and Title 49 of the U.S. Code, sec. 10101 *et seq*.

The statutes have strong similarities in that they both contain a restatement of transportation policy, establish and empower a regulatory body (albeit with powers substantially reduced from those of their predecessors), and contain a set of provisions governing such matters as market entry and exit by rail carriers, rate and service standards, interchange and access, tariffs and confidential contracting, *et al*. Both statutes fall squarely within the North American deregulatory stream of the last decades of the Twentieth Century that saw a steady and marked departure from the intensive and detailed (and, as it turned out, costly and, ultimately, stultifying) regulation predicated on a concept of carrier market dominance that was no longer apposite. Both statutes have addressed the fall-out issue of what recourses do shippers require in circumstances where the question of an imbalance of market power arises.

Yet the two statutes are, as shown below, also very different, reflecting not only a different choice of vehicles to deal with the same gamut of issues, but also the differences between the political economies of the two countries where their geography, demographics, and history have conditioned different societies and governmental structures with different approaches to economic issues.

Overall, Canada has been more comfortable with governmental intervention in the marketplace. The United States current regulatory scheme was shaped in an era when the railway industry was in a precarious financial position, much of it in or at the brink of bankruptcy, a parlous situation that the Canadian railways envisioned but did not have to face. Canada has been characterized by a two transcontinental railway industry model (one of them state-owned for nearly all its existence): the United States has had a multiplicity of railroads, none transcontinental and only one Class I carrier (briefly) state-owned. The United States has had stronger intermodal competition from water carriers and a more built-up interstate highway system. Given the two nations individualities, it is by no means clear that a "one-size-fits-all" approach would work for the two countries' systems of economic regulation of railways.

Both countries' legislators have attempted to strike a balance between shipper and rail carrier interests. Both are in the process of continually recalibrating that balance in response to developments in technology, the market for railway services, and developments in market structure (in particular, the diminution in the number of Class I carriers and the multiplication in the number of regional carriers or short lines). Proponents of one faction or the other often point to the existence of measures on the other side of the border that are deemed to be more or less friendly to their interests. What must be borne in mind is that these individual provisions exist in a matrix of provisions that aim to strike and maintain a competitive balance and grew out of their own jurisdiction and marketplace. A cross-border transplant may not find fertile soil.

2.0 Transportation Policy Statement

Canada has no statement of transportation policy specifically directed towards the railway system; rather, there is a general national transportation policy set out at sec. 5 of the CTA that subsumes railways. It declares that a "safe, economic, efficient and adequate network of viable and effective transportation services…that makes the best use of all available modes of transportation at the lowest total cost" is essential. Those objectives are stated to be most likely to be achieved when all carriers are able to compete…under conditions ensuring that

- the system meets the highest practicable safety standards;
- competition and market forces are, whenever possible, the prime agents in providing viable and effective transportation services;
- economic regulation is limited to those services and regions where regulation is necessary to serve the needs of shippers and travellers, and regulation will not unfairly limit the ability of any carrier or mode to compete freely;
- transportation is recognized as a key to regional economic development;
- each carrier or mode, as far as practicable, bears a fair proportion of the costs of resources provided to them at public expense;
- each carrier or mode, as far as practicable, receives fair and reasonable compensation for what it is required to provide as an imposed public duty;
- each carrier or mode, as far as practicable, carries traffic to or from any point in Canada under fares rates and conditions that do not constitute an unfair disadvantage in respect of any such traffic, an undue obstacle to the movement of persons, or an unreasonable discouragement to development; and
- each mode of transportation is economically viable.

The United States legislation contains a summary statement of purpose for the Department of Transportation at sec.101 to the effect that national objectives "require the development of transportation policies and programs that contribute to providing fast, safe, efficient and convenient transportation at the lowest cost. The policy of the United States Government in so far as railways are concerned is set out in detail in fifteen not wholly reconcilable statements found at sec. 10101.

That policy is strongly deregulatory in that it is aimed at reducing the scope and intensity of regulation

- to allow, to the maximum extent possible, competition and the demand for services to establish reasonable rates for transportation by rail;
- to minimize the need for regulatory control over the rail transportation system and to require fair and expeditious regulatory decisions when regulation is required;
- to promote a safe and efficient rail transportation system by allowing rail carriers to earn adequate revenues, as determined by the (Surface Transportation) Board;
- to ensure the development and continuation of a sound rail transportation system with effective competition among rail carriers and with other modes;
- to foster sound economic conditions in transportation and to ensure effective competition and coordination between rail carriers and other modes;
- to reduce regulatory barriers to entry and exit from the industry;
- to encourage honest and efficient management of railroads;

- to ensure the availability of accurate cost information in regulatory proceedings, while minimizing the burden on rail carriers of developing and maintaining the capability of providing such information; and
- to provide for the expeditious handling and resolution of all proceedings.

However, there are a number of countervailing policy statements indicating recognition by the government that there remain areas in which, notwithstanding a confident reliance on competition and market forces, the need for economic regulation is still discerned:

- to maintain reasonable rates where there is an absence of effective competition and where rail rates provide revenues which exceed the amount necessary to maintain the rail system and to attract capital;
- to require rail carriers, to the maximum extent practicable, to rely on individual rate increases, and to limit the use of increases of general applicability; and
- to prohibit predatory pricing and practices, to avoid undue concentrations of market power, and to prohibit unlawful discrimination.

The remaining three statements deal with public health and safety, railway employee wages and working conditions, and the promotion of energy conservation.

The two policy statements are obviously similar in their overall tenor. The differences between them are largely attributable to context. The Canadian policy statement speaks in terms of viable and effective transportation services and of modes being financially viable. The American policy statement is more direct: it speaks to rates for rail transportation and allowing individual rail carriers to earn adequate revenues.

3.0 The Regulatory Body

The Canadian Transportation Agency is established under sec. 7 of the CTA: the Surface Transportation Board under sec. 710 of Title 49 of the U.S. Code. Both are administrative agencies and quasi-judicial bodies, invested with extensive investigative, process and enforcement powers, and with broad stated jurisdictions in so far as their powers and duties under their constating statutes (and other legislation) are concerned. As noted below, the STB is also invested with quasi-legislative authority.

An immediate indication of the most significant difference in the two regulatory bodies *per se*, as opposed to differences in the duties they discharge, is given by the Canadian regulator's characterization as an "agency." In certain material particulars the Canadian Transportation Agency more closely resembles an arm of the Government of Canada than an independent regulatory tribunal. The powers, duties and functions of the Agency must be exercised in conformity with any policy direction issued to the Agency by the Governor in Council (s. 24); every regulation made by the Agency must be made with the approval of the Governor in Council (s. 36); the Governor in Council may vary or rescind any decision, order, rule or regulation of the Agency (s. 40); the Governor in Council may issue binding policy directions to the Agency (s. 43); and the Minister of Transport may direct the Agency to inquire into any matter or thing concerning transportation and report the findings on the inquiry to the Minister as and when the Minister may require (s. 49).

By contrast, the members and personnel of the Surface Transportation Board are not responsible to or subject to the supervision of or the direction of any officer, employee, or agent of any other

part of the Department of Transportation (s. 703). Nor may any officer of any government agency impose conditions on or impair communications by the Board directly with Congress (ss. 703(g)).

Parliament has created the Canadian Transportation Agency in great degree as an administrative agent of government: Congress has made the Surface Transportation Board an independent tribunal. Its actions are subject only to judicial review to assess whether the STB complied with its statutory mandate or, in quasi-judicial proceedings, to address whether its conclusions were supported by substantial evidence or were otherwise arbitrary or capricious.

4.0 Market Entry

Both jurisdictions have placed the barrier to entry into the railway industry at a low level. Market entry through the construction or operation of a line of railway has a very low barrier in Canada. All that is required, apart from the capital needed to acquire the railway undertaking proper, is a certificate of fitness (s. 90). Acquisition of ownership in a line is not a prerequisite: a leasehold interest or control, direct or indirect, of a person who owns or leases the railway is sufficient (ss. 91(1)).

An application for a certificate of fitness for the construction or operation of a line of railway must specify the termini and route of the line and satisfy the Agency that there will be adequate liability insurance coverage, which may be self-insurance. That having been done, the Agency must grant the certificate.

A railway company may not construct a railway line – other than one within an existing right-of-way, or one no farther than 100 m from the centre line of an existing railway line for a distance of no more than 3 km - without the approval of the Agency (ss. 98(1)). That approval is to be granted if the location of the railway line is reasonable, taking into consideration requirements for railway operations and services, and the interests of the localities that will be affected by the line (s. 98).

The American counterpart is found at sec. 10901 of Title 49. Board certification is required before a person may construct a line extension, an additional line, operate over any extended or additional line, or, if the person is not already a rail carrier, acquire a railroad line or acquire or operate an extended or additional line. Regulatory review under sec. 10901 is not required for the construction of purely private rail facilities owned by and serving only a single shipper, nor for spur, industrial, team, switching or side tracks (s. 10906). Further, the STB has issued a class exemption under sec. 10502 for all rail line construction projects that connect existing rail lines and are constructed entirely within existing railroad rights-of-way, or on land owned by the connecting railroads.

The presumption is in favour of the construction: the Board must issue the certificate applied for unless it finds that the project is inconsistent with the public convenience and necessity. In other words, the provision does not put the onus on the applicant to positively establish that public convenience and necessity require the issuance of the certificate. In recent years the only projects not approved or exempted have been those in which adverse environmental or safety impacts could not be mitigated effectively.

5.0 Market Exit

The Canadian statutory schema for the sale or discontinuance of the operation of a line of railway has been highly liberalized. The sale, lease or other transfer of a railway line, or of an operating interest in a line, for continued operation is not regulated under the CTA (ss. 141(3)). Trackage such as yard tracks, sidings, spurs and auxiliary track are also unregulated (s. 140). The generally applicable provisions governing discontinuance have also been made significantly less onerous; however, particular provisions have been engrafted onto the schema in order to address domestic policy considerations surrounding the issues of passenger transportation and Canada's traditional intensive concern with the effectiveness of the grain handling system in the West.

Every railway company is required to maintain a public plan showing those lines that it intends to discontinue operating in the next three years (ss. 141(1)), and may take no steps to discontinue operating a line before it has been indicated for discontinuance on that plan for at least 12 months (ss. 142(2)). The railway company must then advertise the availability of the line for sale, lease, or other transfer for continued operation and its intention to discontinue operations on the line if it is not transferred (ss. 143 (1)). If no purchaser has come forward or if *bona fide* negotiations with prospective purchasers have proven unsuccessful, the railway company is required to offer the line to the several levels of government involved (s. 145) for sale at net salvage value. If no government comes forward to purchase the line, the railway company may discontinue operating the line on providing notice to the Agency and, as a consequence, is relieved of all obligations under the CTA in respect of the operation of the line (ss. 146(1)).

To accommodate situations in which the line proposed for discontinuance of operations is used in the supply of intercity rail passenger service by VIA Rail Canada Inc., the advertisement of the line must disclose the existence of any agreement with VIA in respect of passenger services on the line if VIA advises the railway company that it agrees to the transfer of the railway company's rights and obligations under the agreement to the acquirer of the line or interest therein (ss. 143(3)). If VIA has not expressly agreed to the transfer, the agreement terminates in respect of the line of railway on the effective date of the transfer of the line (ss. 143(4)). Once a railway company has discontinued operations in compliance with the CTA or has transferred its interest in the line through a sale, lease or other transfer under the discontinuance public or governmental offer process, it is relieved of any obligations with respect to VIA operations over the railway line.

There are two special provisions with regard to the grain network, which owing to its importance to the Canadian economy, and especially its vital role in the economy of the Prairie Provinces, has traditionally been regulated differently and more intensively than the rest of the railway network. The first is a requirement that a railway company that sells, leases or otherwise transfers a portion of a listed grain-dependent branch line to a person who intends to maintain it in operation must continue to operate the remaining portion for at least three years, unless the Minister of Transport determines that it is not in the public interest (ss. 141(4)). The second is a requirement that the railway company pay what is essentially an exit fee when it discontinues operation of a listed grain-dependent branch line: to each municipality or district through which a listed grain dependent branch line runs, three annual payments of $10,000 per mile of the line located in that municipality or district (s. 146.1).

The United States process is generally similar. Line abandonments and discontinuances of operations of rail transportation are regulated and may be carried out only in accordance with the statutory procedure set out at sec. 10903 *et seq*. however, auxiliary trackage (spur, industrial, team, switching or side tracks) are excepted from the authority of the STB (s. 10905).

Every rail carrier must maintain a complete diagram of its transportation system and keep it up to date. The diagram must include a detailed description of each of its railroad lines potentially subject to abandonment and identify each line for which the rail carrier plans to file an application to abandon or discontinue (ss. 10903(c))

The rail carrier must file an application that includes a summary of its reasons for the proposed abandonment or discontinuance; a statement that interested persons are entitled to make recommendations to the STB on the future of the line; and a statement that the line is available for subsidy or sale, together with specified financial information relating to the line (par. 10903(a)(2)). There are extensive notice and notification provisions (par. 10903(a)(3)). Protection of the interests of employees is a pre-condition to the approval of the application (par. 10903(b)(2)).

Abandonment or discontinuance is permitted only if the STB finds that "the present or future public convenience and necessity require or permit" the abandonment or discontinuance, and in making its finding the Board is directed to consider whether the abandonment or discontinuance will have a serious, adverse impact on rural and community development (par. 10903(d)). If the Board finds public convenience and necessity, it is to approve the application as filed or with modifications required by public convenience and necessity; if it fails to find public convenience and necessity, it is to deny the application (par. 10909(d)).

As in Canada, there are provisions facilitating the entry of a financially responsible person into the process. Before the abandonment application is made (s. 10907), that person may intervene to acquire a line that is on a system diagram map required under section 10903. After the application is made, that person may intervene either to acquire the line or, in an additional modality not found in Canada, to provide a subsidy that will allow the line to be kept in operation. If the parties fail to agree on the sale price or on the amount of the subsidy, the Board is empowered to determine a price, not below fair market value, or a subsidy, equal to the difference between the revenues attributable to the line in question and the avoidable cost of providing rail service on the line, plus a reasonable return on the value of the line (ss. 10904(f)).

Carriers seeking to abandon out-of-service rail lines may qualify for a class exemption, eliminating the need for prior regulatory review, if the line has carried no local traffic for at least two years and if any overhead traffic can be re-routed over other lines (49 CFR s. 1152.50(h)).

Abandonment of a line extinguishes the obligation of the rail carrier to provide transportation on that line (ss. 10904(g)).

6.0 Level of Service

Both the CTA and Title 49 impose extensive level of service obligations on railways in restatements of their common carrier obligations.

In Canada, a railway company is required, in accordance with its powers, to furnish adequate and suitable accommodation for receiving and unloading all traffic offered for carriage; to furnish adequate and suitable accommodation for its carriage, unloading and delivery; to receive, carry and deliver traffic without delay and with due care and diligence; to furnish and use all proper appliances, accommodation and means necessary for those functions; and to furnish any other customary or usual service incidental to railway transportation (ss. 113(1)).

Traffic must be taken, carried and delivered on payment of the lawfully payable rate (ss. 113(2)). A shipper who provides its own rolling stock is entitled upon request to specific reasonable compensation therefore (ss. 113(3)).

A railway company must afford all persons adequate and suitable accommodation for receiving, carrying and delivering traffic on and from its railway, for the transfer of traffic between railways, and for the return of rolling stock (ss. 114(1)). Further, railway companies are required to afford to abutting or intersecting railways all reasonable facilities for delivering to or receiving from or carrying by its railway without unreasonable delay all traffic arriving by that other railway (ss. 114(3)).

If the Agency finds that a company is not fulfilling any of its service obligations, it has extremely broad remedial powers. It may order that specific works be constructed or carried out, property be acquired, railway equipment be allotted or used as specified by the Agency, or any specified steps, systems or methods be taken or followed by the railway. It may also specify maximum charges that may be made by the company and order that the company fulfil the obligation to which the complaint related in any manner and within any time or during any period that the Agency deems expedient (ss. 116(4)).

Stemming from the same common law roots, the analogous American provisions are similar. A rail carrier must provide transportation or service at reasonable cost; shall provide to any person on request its rates and other service terms; may not increase any common carrier rate or change any common carrier service term without specified notice; make available and retain for public inspection its common carrier rates and service terms, and any proposed and actual changes thereto, for the transportation of agricultural products; and shall provide transportation or service in accordance with those rates and service terms (s. 11101).

A rail carrier must furnish reasonable, proper and equal facilities that are within its power to provide for the interchange of traffic between, and for the receiving, forwarding, and delivering of passengers and property to and from its line and the connecting line of another rail carrier (s. 10742). No rail carrier may enter into a combination or arrangement to prevent the carriage of freight from being continuous from origin to destination (s. 10744). A railway carrier may establish an allowance or charge payable to a shipper who furnishes a service or instrumentality used in the transportation of the shipper's property (s. 10745).

If, on complaint and after a hearing, the STB finds that a rail carrier has failed to furnish safe and adequate car service or has failed to establish, observe and enforce reasonable rules and practices

on car service, the Board has authority to require a rail carrier to provide facilities and equipment that are reasonably necessary to furnish safe and adequate car service (ss. 11121(a)).

7.0 Rate Provisions

The comparison of the rate provisions in the CTA and Title 49 is most difficult. Although both regimes are market-oriented and far cries from the intensive rate and service regulation that applied before the *National Transportation Act, 1967* in Canada and before the *Staggers Act* of 1980 in the United States, the approach of the two statutes differs fundamentally, precluding a one-to-one comparison in many aspects of the regime.

Congress has chosen to rely more heavily on the workings of competition and market forces, with regulation intervening somewhat sparingly by Canadian standards. While the statutory formulation is that rates are to be reasonable, a great deal of traffic has been exempted from rate regulation altogether, and much of the remainder is effectively excluded from rate regulation because the Board is directed to review the rate in question only if it first makes a finding of market dominance by the rail carrier in respect of the traffic to which the rate applies.

Parliament has chosen for the most part not to regulate railway rates *per se*. Instead, there are a variety of recourses to shippers, rather loosely referred to as "competitive access" provisions that are intended as simulacra for direct intramodal competition and to redress what are perceived to be imbalances in the bargaining positions between shippers and railways in those circumstances where competition and market forces are deemed too attenuated to perform that function.

8.0 Exemptions

In keeping with its strongly deregulatory policy underlying the economic regulation of railways, Congress has directed the STB to exempt "to the maximum extent consistent with this part" persons, classes of persons, transactions or services whenever the STB finds that the application of any provision is not necessary to carry out the transportation policy enunciated at sec. 10101 or is not needed to protect shippers from the abuse of market power (s. 10502). Essentially, an exemption is granted where effective competition for the movements at issue is found to exist.

Wholesale exemptions have been issued by the regulator:

- agricultural commodities, except grain, soy beans and sunflower seeds
- miscellaneous commodities, comprising thousands of classes such as crushed stone and gravel, textiles and apparel, lumber, rubber and plastics, motor vehicle parts, municipal garbage waste, baking products, blast furnace products, iron and steel scrap, miscellaneous products of manufacturing
- all commodities carried in boxcars
- new highway trailers or containers
- trailer-on-flatcar and container-on-flatcar (TOFC/COFC) traffic.

The Agency has been granted no similar exemption authority. Certain specified traffic is excluded by the operation of the Act from specific provisions; e.g., TOFC/COFC from final offer

arbitration (par. 159(1)(b)) and TOFC/COFC and LCL (less than carload) from competitive line rates (ss. 131(3)).

While not entirely on all fours with the STB's exemption power, there are two features of the CTA by which Parliament has given direction to the Agency as to how it should excuse its administrative powers, and which could have the effect of tempering the rigour of the Act in so far as rail carriers are concerned.

The first is sec. 27, which provides in subsection (2) that where an application is made to the Agency by a shipper in respect of any transportation rate or service, the Agency may grant the relief sought in whole or in part, but in making the decision, the Agency must be satisfied that in the particular circumstances "the applicant would suffer substantial commercial harm if the relief were not granted." The circumstances to be considered by the Agency may include, but are not limited to, the market or market conditions relating to the goods; location and volume of traffic; scale of operation; type of traffic or service; the availability of alternative means of transporting the goods; and any other matters that appear to the Agency to be relevant (ss. 27(3)). [The drafting of the subsection is curious: in effect, it provides that the Agency may consider anything that appears to it to be relevant, but is not limited to that.(??)]

Sec. 27 appears to provide that, notwithstanding the literal wording of a provision in the CTA whereby a carrier's rate or service may be contested and the fact that the shipper may have fully made its case thereunder, the Agency in deciding whether to grant relief must, after considering the enumerated circumstances (or such of them as it considers material), decide whether an additional evidentiary burden has been satisfied by the applicant shipper – that is, proof that it would suffer substantial commercial harm. While not as potent as the exemptive power or as striking as the STB's policy of applying a constraining antitrust standard in its competitive access rules, this provision bears some similarity in that it does provide for a general, albeit mild, restraint on the Agency's relief granting power.

The second requirement is sec. 112 of the CTA, which provides that a rate or condition of service established by the Agency under the "Rates, Tariffs and Services" Division of the CTA must be "commercially fair and reasonable to all parties." Again this is a provision of general application, applying to all situations in which the Agency may establish a railway rate or condition of service, and again it restrains, albeit in what would seem to be a highly attenuated fashion, the latitude of the Agency by imposing on it an obligation whether the literal operation of a provision has yielded a result that is technically correct, in the sense of full compliance with the statute, but is still in some way not "commercially fair and reasonable to all parties."

9.0 Tariffs

In both Canada and the United States the former tariff-based regimes under which all rates were required to be set out in tariffs that (i) had been issued, published and filed with the regulator and (ii) under which no rates could be charged other than those so set out in such tariffs have been effectively abolished. Only vestiges remain.

In Canada, the general principle is still set out at sec. 117 that a railway company shall not charge a rate in respect of the movement of traffic unless the rate is set out in a tariff that has been issued and published in accordance with the Act and is in effect; however that provision is made

subject to an exception – a rate set out in a confidential contract entered into under sec. 126. The exception has become the rule, since the bulk of traffic now moves under contract rates. Tariffs are no longer required to be filed with the regulator: they are merely required to be published and either publicly displayed or available for inspection (ss. 117(3)). A freight tariff must be issued at the request of a shipper in respect of the movement of traffic on its railway (s. 118) and increases to a tariff rate require 20 days' advance notice. Tariff rates are deemed to be the lawful rates of the railway company and must be charged until they expire or are superseded by a new tariff (ss. 119(2)).

In the United States, the rules in this regard are, for the most part, even more liberal. Tariffs themselves are generally not required. Instead, rail carriers are required to provide to any person, on request, their rates and other service terms, either in writing or in electronic form (ss. 11101(b)). There is a prohibition on a rail carrier increasing any common carrier rates or common carrier service terms until 20 days have expired after notice, but that notice requirement is limited to only persons who have within the preceding 12 months requested such rates or made arrangements with the carrier for a shipment that would be subject to the increased rates or changed terms (ss. 11101(c)).

There is a more onerous requirement with regard to the transportation of agricultural products (which are defined for this purpose to include grain, grain products and fertilizer). In addition to complying with the general common carrier rate rule, a rail carrier is required to publish, make available, and retain for public inspection its common carrier rates, schedules of rates, and other service terms, and any proposed and actual changes to such rates and service terms (ss. 11101(d)).

10.0 Confidential Contracts

One of the most significant deregulatory changes introduced on both sides of the border in the 1980s was confidential contracts between shippers and carriers covering the rates and conditions for the provision of rail transportation service. In distinction to a full tariff regime in which all rates are to be set out in public tariffs, tariff rates must be charged, and no rates other than tariff rates may be charged, confidential contracts have allowed railways and shippers to craft rate and service arrangements particular to their own needs. The concept, allowing shippers and carriers to effectively tailor their own transportation regimes, which they agree to keep confidential, has been an overwhelming success, garnering strong support from both shippers and carriers.

In Canada, section 126 of the CTA authorizes a railway company to enter into a contract with a shipper that the parties agree to keep confidential respecting the rates to be charged to the shipper; reductions or allowances from tariff rates; rebates or allowances from rates or confidential contracts previously charged; conditions relating to the traffic; and the manner in which the railway company's statutory service obligations are to be fulfilled.

Once a confidential contract has been entered into, the traffic that is subject to that contract is largely removed from the operation of the Act. The parties may vary the railways' statutory service obligations by specifying the manner in which those obligations are to be fulfilled (ss. 113(4)), and the terms of the contract are binding on the Agency in the event of any complaint and investigation of the company's service obligations (ss. 116(2)). A confidential contract

overrides the general provision set out in subsec. 116(5) to the effect that a railway company is not relieved from an action taken by an aggrieved person for any neglect or refusal in meeting its statutory service obligations where that action arises from any negligence or omission of the company or any of its employees. Confidential contracts are effectively immunized from submission to final offer arbitration by the statutory prohibition of the submission of any matter governed by a confidential contract to final offer arbitration without the consent of all parties to the contract (ss. 126(2)). It is implicit in the Act that the existence of a confidential contract respecting the movement of traffic is inconsistent with the establishment by the Agency of a competitive line rate governing that same traffic.

In the United States, sec. 10709 of Title 49 sets out a very similar arrangement. One or more rail carriers may enter into a contract with one or more shippers to provide specified services under specified rates and conditions (ss. 10709(a)); and a party to such a contract has no duty in connection with the services provided under the contract other than those specified in the contract (ss. 10709(b)). Further, the contract and the transportation performed under it are removed from the application of the rates and services provisions of the Act and may not be challenged before the Board or in any court on the ground that it constitutes a violation of the Act.

Title 49 also retains, albeit in limited circumstances, two features that have been dropped from the Canadian statute: the filing of contract summaries with the regulator and "third party appeals" against confidential contracts. A summary of each contract for the transportation of agricultural products must be filed with the Board so that the essential terms are available to the public (ss. 10709(d)). Within 30 days of the filing of a contract summary, the Board may, on complaint, review the contract on the grounds that the shipper will be individually harmed because the contract unduly impairs the ability of the carrier to meet its common carrier obligations to the complainant. In addition, a complaint by a shipper of agricultural commodities may also be made on the ground that the rail carrier has unreasonably discriminated by refusing to enter into a contract with the shipper covering the same type of commodity under similar conditions as the contract at issue or that it constitutes a destructive competitive practice.

11.0 Cost of Capital and Revenue Adequacy

Regulatory determinations of cost of capital are performed under both the Canadian and American legislative schemes in circumstances where an assessment of the cost of providing rail service is required. This is because the cost of the railway assets dedicated to that end include an element of the cost of financing those assets, whether through equity (common or preferred), debt, deferred taxes, or otherwise. The cost of capital is the minimum rate of return on investment that the providers of capital require as a condition for undertaking an investment.

The cost of capital determination examines each of those financing components, assigns a cost rate to each, and then computes a weighted average cost of capital rate for the undertaking. Although each regulator has over the years developed a fairly systematic process for making its cost of capital determinations, the elements of that process and the actual calculations themselves leave significant room for the application of informed discretion on the part of the regulator.

In Canada, although the application of costing methodologies has been significantly narrowed under the CTA, the Agency still has an ongoing costing responsibility, principally with regard to

the setting of the annual maximum revenue entitlement of prescribed railway companies for the transportation of western grain pursuant to the sec. 151 of the Act and the setting of interswitching rates under sec. 128 of the Act.

In essence, the Agency determines the cost of capital rate through a four-part process:

1. It begins by determining the railway company's net rail investment. Net rail investment is derived by adding net assets (book value less accumulated depreciation) and working capital (cash and materials needed to support day-to-day operations).
2. Then the capital structure is determined by combining instruments the railway uses to fund its investment in its railway assets. This is typically long-term debt, common equity, and deferred taxes.
3. Then the cost of financing is determined. Each component of the capital structure has a different cost. The cost of debt is easily derived from the firm's debt service costs. The cost of deferred taxes is deemed to be zero because the firm does not pay an interest premium or compensate any party to obtain them. The cost of common equity is a more problematic issue because it cannot be measured directly and must be derived. The Agency therefore uses three market-driven models to calculate the required rate of return:
   - The DCF (discounted cash flow) method, in which the cost of common equity rate is deemed to be equal to the sum of the current dividend yield plus the expected future growth rate in dividends;
   - The CAPM (capital asset pricing model) method, which measures the cost of common equity rate as the sum of a risk-free rate of return plus the risk premium on a portfolio representing the market as a whole multiplied by the riskiness of the railway company relative to the riskiness of the market as a whole; and
   - The Risk Premium model, which measures the yield on current Government of Canada bonds and adds a premium for the additional risk of common equity over Government of Canada bonds.

   The agency assesses the results of each of the methodologies and then applies informed judgement to make its determination of the cost of common equity rate.

4. The final step is the determination of the cost of capital rate itself. The cost of financing each component of the capital structure, determined at step 3, is weighted according to its proportion of the firm's total capital structure. Then the weighted cost of equity is grossed up to account for the effect of income taxes. The weighted cost of debt and deferred taxes is then added to the resulting cost of equity that has been adjusted for income taxes, yielding the final result, the weighted average cost of capital rate for the railway company.

It should be noted that Canada's peculiar railway industry structure has necessitated certain unusual variations in the Agency's actual exercise of its cost of capital determination methodology. One is that the Canadian Pacific Railway Company's cost of common equity is indirectly determined by using that of its parent company, Canadian Pacific Limited, since the latter is the publicly traded and dividend-paying entity and has the historical market information available to determine the cost rate. Another is that it is the Canadian Pacific Railway Company's cost of common equity rate that is used in the determination of Canadian National Railway Company's cost of common equity rate. This is a hold-over from the period when Canadian National was a government-owned corporation and will probably remain the case only

until the Agency finds that there is enough market information available to allow for a separate determination of Canadian National's cost of common equity rate.

The methodology used by the STB is roughly similar to that employed in Canada. The reason why a cost of capital determination is required is very different and, of course, the distinctly different market structure results in different modalities of application.

Each year the STB initiates a proceeding to determine the railroads' cost of capital for the year in order to enable it to make the statutorily required annual individual railroad revenue adequacy determination (ss. 10704(3)). The STB is required to maintain and revise as necessary standards and procedures for establishing rate levels for rail carriers that are adequate to cover operating expenses plus a reasonable and economic profit or return on capital employed in the business. The Board is directed to make an adequate and continuing effort to assist the carriers in attaining revenue levels prescribed in that provision (par. 10704(a)(2)). The revenue adequacy test has no immediate consequences, but it has a great deal to do with the attitude which the regulator is to bring to bear.

The current cost of capital is, for the present at any rate, the sole standard of revenue adequacy. The test is whether the individual railroad has earned in after-tax income from railroad operations a return for the year on its capital invested in its railroad assets that equals the composite cost of capital for the industry.

The STB has adopted a composite railroad approach to computing an industry-wide cost of capital, using industry-wide debt/equity ratios and costs of debt and equity. Included in the composite railroad sample are those companies that operate a Class I railroad, whose parent companies have at least 50 percent of their assets devoted to rail operations, are listed on the New York or American Stock Exchange, have investment grade debt (i.e. senior debt securities rated from AAA to BBB), and pay dividends throughout the year in question. The sample range currently captures the Burlington Northern Santa Fe, Conrail (owned by CSX and NSC), CSXT, Grand Trunk Western and Illinois Central (of both of which Canadian National is the parent company), Kansas City Southern, Norfolk Southern, Soo Line (owned by Canadian Pacific Limited) and Union Pacific. Conrail is currently excluded on the dividend test; Soo line on the 50 percent of parent assets test; and the two CN-controlled lines because CN is a Canadian railroad and the cost of capital proceeding is concerned with determining costs for U.S. railroads under STB jurisdiction.

The calculation of the industry-wide weighted average current cost of capital proceeds on much the same basis as in Canada, except that market values of common equity, preferred equity and debt are used to calculate the composite capital structure, deferred taxes are not included in the calculation, and the debt rate is calculated using current market figures and not historical data, and only the DCF method is used in the cost of equity rate determination.

In contesting certain shippers' demands for increased competitive access, American railroad companies can point to the fact that they chronically fail to earn their cost of capital determined by the STB. Their opponents point out that the railway companies still seem to be able to raise sufficient capital for their needs and have been willing to re-invest their earnings rather than pay them out in dividends, and assert that there is something fundamentally wrong with the process. In response, the railways invoke their currently poor earnings and markedly depressed stock prices.

12.0 Final Offer Arbitration

Final offer arbitration is a vehicle for the resolution of disputes between shippers and carriers that is provided for in the Canadian regulatory scheme. It has no analogue in the American regulatory scheme. First developed and applied with respect to contractual salary disputes between baseball club owners and players and between municipalities and civic worker bargaining units, it is an intentionally high-risk form of arbitration in which the arbitrator must select one of the final offers put forward by the parties. By foreclosing the option of any type of compromise or saw-off position, the process design encourages the parties to settle the dispute through their own negotiations rather than resort to a third-party decision maker. Should they nonetheless proceed to arbitration, the process design disciplines the parties to advance tempered final offers. The more reaching a party's position, the greater the likelihood that the other party's final offer will be selected by the arbitrator.

Only shippers may invoke the final arbitration process: a shipper who is dissatisfied with either the rate or conditions associated with a movement of goods may, if the shipper and carrier cannot resolve the matter, submit the matter in writing to the Agency for final offer arbitration (ss. 161(1)). The submission must also be served on the carrier and must include the shipper's final offer (excluding any dollar amounts) and its undertaking to ship the goods in question in accordance with the decision of the arbitrator (ss. 161(2)). Within ten days of the service of the submission, the shipper and carrier must submit to the Agency their final offers, including dollar amounts. The Agency then refers the matter to an arbitrator or panel of arbitrators chosen from a public list maintained by the Agency of persons who have agreed to, and are qualified, to act as arbitrators (s. 169). The process is to be conducted as expeditiously as possible (ss. 163(2)). An accelerated procedure is provided for – one that dispenses with the exchange of information procedures, interrogatories, and additional information requests by the arbitrator – when freight charges at issue do not exceed $750,000 and the shipper did not indicate a contrary intention when submitting the offer (s. 164.1).

The decision of the arbitrator is the selection of the final offer of either the shipper or the carrier (ss. 165(1)); is to be awarded within 60 days of the submission (par.. 165(2)(b)), and applies for up to one year (par. 165(2)(c)).

Final offer arbitration was introduced in Canada with the enactment of the National Transportation Act, 1987 as one of a suite of provisions created under that act to enhance the bargaining power of shippers and, in particular, shippers served by only one railway. Nevertheless, the CTA does not limit the application of final offer arbitration only to "captive" shipper situations: it applies to the carriage of goods by railways generally, other than goods carried in trailers or containers on flat cars unless the containers are moved to or from a port served by only one rail carrier (par. 159(1)(b)). The application of final offer arbitration is not statutorily conditioned on the absence of intramodal or intermodal competition or other market factors, although the arbitrator must, in rendering a decision, have regard to whether there is available to the shipper "an alternative, effective, adequate and competitive means of transporting the goods to which the matter relates."

In other words, the statue permits a shipper who enjoys competitive alternatives to have recourse to final offer arbitration but discourages that shipper from doing so.

13.0 Interswitching and the Use of Terminal Facilities

Interswitching is a service provided by railway companies inter se whereby one carrier upon whose lines the origin or destination of a movement is located performs the pick up or delivery of the car or cars in which the traffic is carried, which is then handed on to or has been received from the line haul carrier that performs the bulk of the movement. The statutory provisions governing interswitching in Canada and the United States are not dissimilar, but regulatory interpretation has created two very different regimes.

In Canada, interswitching has been a commonplace feature of the railway environment since it was statutorily entrenched at the beginning of the Twentieth Century. Originally introduced as a measure to avoid congestive overbuilding of railway lines, particularly in urban centres, interswitching was mandated within four miles of an interchange. The scope of the provision has been significantly extended under the current legislation and the Railway Interswitching Regulations (“RIR”). That scope has been extended in two ways. In a literal sense, the distance within which the interswitching provisions apply have been much expanded. In a policy sense, interswitching has been developed beyond its original anti-congestion purpose to serve as one of several competitive access provisions contained in the CTA.

Sec. 127 provides that where a line of a railway company connects with a line of another railway company, an application for an interswitching order may be made to the Agency by either company, by a municipal government or by any interested person, and the Agency may order the railway companies to provide reasonable facilities for the convenient interswitching of traffic in both directions at an interchange between the lines of either railway company and those of other railway companies connecting with them. Further, if the origin or destination of the movement is within a radius of 30 km, or a prescribed greater distance, of an interchange, the traffic may not be transferred except in accordance with the RIR determining terms and conditions, interswitching rates, and prescribing distances greater than 30 km. Presumably to preserve the terminal carrier’s incentive to invest in its own operations, facilities such as bulk transfer facilities or container terminals are exempt from such access (RIR s. 2).

The interswitching provisions themselves do not appear to expressly require interswitching. They merely empower the Agency to order interswitching rather than making it expressly mandatory: they do not expressly require interswitching to be carried out within 30 km of the interchange, but rather prohibit interswitching within the 30-km limit other than in accordance with the regulations. Still, the fact “on the ground” is that owing to the railway companies’ level of service obligations and long-established convention and practice, the availability of interswitching within a 30-km limit is ubiquitous. (The 30-km limit is not absolute, but may be extended if the Agency is of the opinion that, in the circumstances, the point of origin is “reasonably close to the interchange” (ss. 127(4)). The terminal carrier is required at all times to furnish to interswitched traffic a level of service equal to that accorded by the terminal carrier to its own line haul traffic (RIR s. 4).

Pursuant to its regulation making power, the Agency has adopted regulations that establish a rate matrix of car block sizes and distance zones that determine what maximum interswitching charge is to apply. It should be noted that the rate must not be less than the variable costs of moving the traffic as determined by the Agency. The calculation of the rate does not concern itself with either the revenue adequacy position of the terminal carrier nor the question of any forgone contribution to constant or fixed costs that might have been made by the terminal carrier if it had

been permitted to carry the traffic for the full extent of the movement or for a greater proportion of it. Nor does it concern itself with the quality or competitiveness of the service that the terminal carrier actually provides or would be prepared to provide to the shipper.

Sec. 11102 of Title 49 governs the use of terminal facilities. It provides for two types of competitive access provisions: terminal running rights and reciprocal switching.

The STB may require terminal facilities, which may include main-line tracks for a reasonable distance, owned by one carrier to be used by another carrier if the Board finds it to be practicable and in the public interest without substantially impairing the ability of the owning carrier to use the facilities to handle its own business. If the carriers cannot themselves agree upon the terms and compensation, the Board is empowered to set them.

Unlike the case with respect to the majority of the provisions addressed in this memorandum, Canada does not have an analogous terminal running rights provision per se. Terminal running rights were included in the proposed legislation that eventually became the National Transportation Act, 1987, but the feature was dropped from the bill, probably because it was considered surplusage in light of the introduction of, inter alia, extended interswitching, final offer arbitration and competitive line rates as attempts to enhance or increase the intensity of competition and market forces. There is a provision which empowers the Governor in Council to request two or more railway companies to consider joint or common use of a right-of-way where the Governor in Council believes that such use may improve the efficiency and use of rail transport and would not unduly impair the commercial interests of the companies (s.139), but that is an efficiency-related provision and not a competition-related one.

The Board may require rail carriers to enter into reciprocal switching agreements where it finds them to be practicable and in the public interest or necessary to provide competitive rail service. If the rail carriers cannot agree upon conditions and compensation, the Board may establish them (ss. 11102(c)).

The STB's powers to order use of terminal facilities and reciprocal interswitching are clear, broad, summary, and little exercised. In fact, the STB, or, more precisely, its predecessor, the ICC, has read those powers down considerably.

Notwithstanding the "practicable and in the public interest" test set out in the statute, the ICC took the view that its mandate directed it to focus on correcting abuses and not on a restructuring of the railroad industry (which, it considered, would result if it were to freely order competitive access, use of terminal facilities and reciprocal switching). It therefore exercised its discretion on policy grounds to demand the satisfaction of further criteria before it would order terminal running rights or reciprocal switching; that is, whether the rail carrier on whose lines the traffic is located has engaged in or is likely to engage in conduct that is contrary to the rail transportation policy or is otherwise uncompetitive. The ICC, borrowing an antitrust approach, set the essential questions as follows:

(1) Whether the railroad has used its market powers to extract unreasonable terms on through movements; or
(2) Whether because of its monopoly position it has shown a disregard for the shipper's needs by rendering inadequate service.

Absent the satisfaction of those conditions, it would not order the competitive access applied for. (See Midtec Paper Corporation, 3 ICC 2d 171; 857 F.2d 11487, 273 U.S.App.D.C. 49 (1988)).

14.0 Competitive Line Rates

Competitive line rates were the most controversial feature of the National Transportation Act, 1987. Captive shippers were transported by them: carriers railed against them. There is no analogue in United States, but the "Bottleneck" competitive access issue, which competitive line rates squarely address, remains what is arguably the most contentious issue on the shipper/rail carrier front in the United States.

Competitive line rates apply where a shipper has access to the lines of only one railway company at the origin or destination of the movement of the shipper's traffic and a continuous route between those points is operated by two or more railway companies (ss. 129(1)). The shipper, after entering into an agreement with the connecting carrier for the line haul of the movement, may require the local carrier to establish a competitive line rate between the point of origin or destination, whichever it exclusively serves, and the nearest interchange with the connecting carrier (ss. 131(1)). In effect, that means that the local carrier must yield the line haul to the connecting carrier notwithstanding its ability to carry the traffic for the full distance of the movement.

Competitive line rates do not apply to TOFC/COFC or LCL movements, unless they arrive at a port in Canada by water for movement by rail or by rail for movement by water (ss. 131(3)). The parties of the movement in respect of which a competitive line rate may be established must not as a rule exceed 50 per cent of the total movement or 1,200 km, whichever is greater (ss. 131(4)).

Where the railway company and the shipper do not agree on the competitive line rate, the Agency is empowered to establish

- the amount of the rate
- the route
- the interchange point, and
- the service obligations to be fulfilled by the local carrier.

It will be apparent that this provision effectively reduces the relative negotiating power of the railway company vis a vis the shipper and will consequently tend to result in lowered railway rates. In fact, the primary result of the existence of competitive line rates has been the mitigation of the rates that captive shippers pay by an unknown and essentially unknowable amount. This is because while there have been relatively few competitive line rates ordered (since railway companies have preferred to keep the traffic and retain some contribution from it), the mere existence of the competitive line rates provisions has shifted the power balance considerably.

The calculation of the amount of the competitive line by the Agency rate is formulaic. The first 30 km are simply charged at the interswitching rate. The balance of the movement is priced by multiplying two elements: the first is the total revenue that the local carrier received over all its lines in respect of the movement of similar traffic during a designated period divided by the total tonne kilometres of that traffic; and the second is the number of kilometres over which the competitive line rate is to apply minus the number of kilometres to which the interswitching rate applies (ss. 133(1)).

The result is intended to create a rate that mimics what the rate would be if the traffic were carried under market conditions that were averages of those that applied with respect to similar

commodities all over the railway company's system. The equity of this concept, whether the formula does yield a reasonable result, and what the effects of such pricing are on the carrier's long-term financial viability remain matters of animated debate.

The Bottleneck issue in the United States involves situations where more than one carrier could be involved in providing rail service from an origin to a destination. In a bottleneck situation only one carrier serves an origin or destination (or both) and solely provides single line service over the entire route or is capable of solely providing transportation service over a portion of the through route. However, another carrier or carriers (the non-bottleneck carrier(s)) could provide service over a portion of the through route as an alternative to service by the bottleneck carrier or could provide service in competition with other non-bottleneck carriers in the through route.

The issue is whether a bottleneck carrier should be required to establish a separately challengeable rate for traffic on the bottleneck segment only, which a shipper could then challenge as unreasonable under maximum rate regulation (and in some instances where it otherwise provides single line service could be compelled to short haul itself and carry the traffic on the bottleneck segment only, rather than for the entire through route), even if the rate for the entire route is not unreasonably high.

In December 1996, the STB decided three bottleneck cases brought by several coal shipping utilities. The STB generally affirmed the principle that railroads should not have to short-haul themselves. The STB stated that the shippers "seek through regulation to deprive carriers of their statutorily-recognized long-haul and their traditional routing discretion." It also concluded that a carrier did not have to provide a separately challengeable rate for a portion of a through route. However, the STB did establish an exception to the general rule. It found essentially that if a shipper had entered into a contract with a non-bottleneck carrier over the non-bottleneck segment of a route, the shipper could, in certain circumstances where the bottleneck carrier was not able to provide single line service, force the bottleneck carrier to quote a rate for the bottleneck segment.

In February 1999, the Unites States Court of Appeals for the Eighth Circuit affirmed the STB's 1996 decisions. The Court found that "Nothing in the Act explicitly requires carriers to provide separate local rates for the bottleneck portion of through service, and that requiring rail carriers to provide such rates would undermine "the national railroad policy of deferring to carrier discretion in setting routes and rates." The Court dismissed both the utilities' claim that the STB should have forced bottleneck railroads to quote separately challengeable rates for bottleneck segments of through routes in all cases, and the railroad industry's appeal of the part of the STB decision permitting shippers to force a railroad to quote a separately challengeable rate on the bottleneck portion of the movement if the shipper first obtained a contract with another carrier for the non-bottleneck segment.

15.0 Market Dominance

Before the STB can scrutinize the reasonableness of a challenged rail rate or prescribe a maximum reasonable rate, it must first find that the carrier has "market dominance over the transportation to which the rate applies" (ss. 10707(b)). "Market dominance" is defined as "an absence of effective competition from other rail carriers or modes of transportation to which a rate applies" (ss. 10707(a)).

In theory at least, the market dominance inquiry is also entirely distinct from the assessment of rate reasonableness, because the statute provides that a finding of market dominance does not establish a presumption that a proposed rate exceeds a reasonable maximum. In fact, there is a conclusive presumption that a rail carrier does not have market dominance over transportation if the rate in question generates revenues that are less than 180% of the variable costs of providing the service (ss. 10707(d)). If the rate is above that jurisdictional threshold (the "quantitative market dominance standard"), the STB then proceeds to examine qualitative competitive factors in determining whether a railroad possesses market dominance. In practice, the degree to which a challenged rate exceeds the jurisdictional threshold appears to exert a significant influence on the STB's consideration of the qualitative market dominance issue and of the overall reasonableness of the challenged rate.

The mere existence of a potential competitive alternative to a railroad's services under a challenged rate is not by itself sufficient to establish an absence of market dominance. The competitive alternative must be "effective" in restraining the challenged rate to reasonable levels. In determining whether an identified competitive alternative is effective, the STB has stated that it will consider various factors, such as the physical feasibility of the shipper's use of the alternative, service quality, and the relative cost of the alternative. Thus, if a rail shipper could use alternative truck service, but only at a significant cost increase over rail service at the challenged rate, the intermodal competition is not effective.

When the STB finds that a railroad does possess market dominance over the transportation to which the challenged rate applies, the statute permits it then to determine whether the rate exceeds the maximum reasonable level. Market dominance must therefore be found to exist before the question of rate reasonableness is addressed: it is a two-step logical process. However, under recent practice the proceedings are usually not bifurcated and market dominance and rate reasonableness issues are pleaded, presented and decided in a unitary proceeding.

In considering the qualitative aspect of market dominance, the STB looks into the existence and intensity of intermodal and intramodal competition. Until recently, the examination also included product and geographic competition, but the STB decided earlier this year to no longer permit rail carriers to invoke those two sources of competition. That decision is currently under appeal.

The market dominance provisions have no direct bearing on or relationship to any of the economic regulatory provisions administered by the STB other than the maximum rate reasonableness provisions. The various types of potential effective competition that have been considered by the STB in market dominance cases, however, are the same types of competitive factors that the STB has considered in administering other regulatory provisions, such as the evaluation of the competitive impacts of proposed railroad mergers, consolidations and similar inter-carrier combinations, the determination of whether particular classes of rail transportation should be exempted from regulation, and the assessment of requests for competitive access relief. Thus, the general approach to the analysis of competition in market dominance proceedings has wide application in other areas of the STB's regulatory jurisdiction.

In the area of market dominance, the Staggers Act introduced a provision establishing a conclusive presumption that a railroad does not enjoy market dominance with respect to a challenged rail rate that generates revenues below a specified percentage of the variable cost of the service. Initially established at 160%, the statute provided that it would increase by five

percentage points a year until 1984 and thereafter fluctuate in a defined band in accordance with an industry-wide measure called the "cost recovery percentage." (In practice, the cost recovery percentage was always set at 180% and the Interstate Commerce Commission Termination Act has fixed the quantitative market dominance standard at 180%.) Congress clearly intended by the amendment to withdraw jurisdiction over railroad rates that the ICC would have been able to review under prior law. Implicit in that measure is the proposition that a railroad's ability to charge a rate at or even above the 180% level is consistent with the existence of "effective competition" and the absence of market dominance. This reflects a willingness to allow the railroads to practise differential pricing to recover the system's full costs, including the fixed and common costs; however, the selection of the jurisdictional threshold level at 180% was not based on any specific cost analysis or objective formula and is, to that extent, an arbitrary standard.

The ICC and STB have taken seriously the need to consider whether competition for the railroad whose rate was challenged was "effective." The complaints dismissed on market dominance grounds have been few. No maximum rate complaint has been dismissed on qualitative market dominance grounds since 1991, reflecting at least in part the relatively small number of rate complaints that have been filed during the period and the likelihood that the mere existence of the market dominance standards has deterred shippers from initiating complaints.

16.0 Maximum Rates

Sec. 10701 sets out the general rule in the United States that a rail carrier may establish any rate for transportation or other services it provides. However, a rate established by a rail carrier must be "reasonable" if the STB determines that the carrier has "market dominance" over the traffic in question (par. 10701(d)(1)). Thus, for a shipper to secure remedial rate relief from the Board, the carrier must first be found to exercise market dominance over the traffic. (See "Market Dominance" above.)

If the STB finds that the carrier has market dominance, it then determines whether the rate charged by the carrier exceeds a reasonable maximum. A determination that a carrier has market dominance over the traffic does not establish that the rate is necessarily unreasonable (s. 10707(c)). In determining whether a rate exceeds a reasonable maximum, the Board is required to recognize the policy direction contained in sec. 10101 that rail carriers are to have the opportunity to earn adequate revenues.

16.1 Maximum Rate Reasonableness Standards

The ICC set out the economic standards used to assess maximum rate reasonableness in a proceeding referred to as Coal Rate Guidelines – Nationwide (1 ICC 2nd 520 (1985)). These economic standards are known as "Constrained Market Pricing."

Supplementary to these economic standards, the STB, in 1996, prescribed maximum rate reasonableness standards in cases involving small volumes of traffic (see below).

It should be noted that while the nomenclature of the proceedings implies a distinction between coal and non-coal traffic, this is not the case. The principles set out in the Coal Rate Guidelines apply to all maximum rate reasonableness cases regardless of the commodity, except in those

cases where the shipper can demonstrate to the satisfaction of the Board that the evidentiary requirements are overly burdensome.

16.2 Differential Pricing

In its 1985 Guidelines, the ICC explained that the cost structure of the industry requires railroads to practice differential pricing to recover their constant costs. The Commission stated that differential pricing using Ramsey pricing principles, which are demand-based, was the appropriate pricing mechanism to recover constant ("unattributable") costs.

> "The differential between marginal costs and average costs cannot be assigned directly to specific movements by any conventional accounting methodology. Hence we refer to it as the 'unattributable costs'. These are the costs that must be recovered through differential pricing.
>
> "Any means of allocating these costs among shippers other than actual market demand is arbitrary and may not permit a carrier to cover all of its costs. This is because non-demand-based cost apportionment methods do not necessarily reflect the carrier's ability (or inability) to impose the assigned allocations and cover its costs. Thus, they frequently 'over-assign' or 'under-assign' the carrier's unattributable costs to particular services. If a carrier sought to apply the formula price to all of its traffic, it would lose that traffic for which the price could not support the price assigned. In that event, the remaining shippers might be required to pay a larger portion of the carrier's unattributable costs because they would lose the benefit of sharing those costs with the lost traffic.
>
> "'Ramsey pricing' is a widely recognized method of differential pricing, that is pricing in accordance with demand. Under Ramsey pricing, each price or rate contains a mark-up above the long-run marginal cost of the product or service in order to cover a portion of the unattributable costs. The unattributable costs are allocated among the purchasers or users in inverse relation to their demand elasticity. Thus, in a market where shippers are very sensitive to price changes (a highly elastic market), the mark-up would be smaller than in a market where shippers are less price sensitive. The sum of the mark-ups equals the unattributable costs of an efficient producer.
>
> "Applied to all the railroad industry, Ramsey pricing would permit an efficient carrier to cover all of its costs (including the cost of capital) and thus become revenue adequate. Moreover, the attainment of revenue adequacy would benefit shippers because the industry then would be able to attract all the capital needed to provide and maintain high-quality rail service." (Coal Rate Guidelines, pp. 526-527)

16.3 Constrained Market Pricing

The ICC concluded that strict application of Ramsey pricing would be impractical in railroad rate cases because marginal cost and elasticity of demand would be needed for every shipment carried by the railroad. It therefore adopted "Constrained Market Pricing" as an alternative to pure Ramsey pricing as its maximum rate reasonableness standard:

> "As an alternative to Ramsey pricing, we proposed Constrained Market Pricing. Under CMP, the carriers are expected to use the market demand which they observed as the

> basis for their pricing, but they need not calculate the precise elasticity of demand for every movement. Indeed, where information on demand elasticity is required under the CMP methodology, we will consider qualitative (rather than necessarily quantitative) evidence on the relative demand elasticity of specific movements and/or commodities. We are satisfied that the constraints and incentives should lead to rates approximating Ramsey prices and protect captive coal shippers from possible carrier abuse of pricing discretion." (Coal Rate Guidelines p. 527)

Under CMP, a railroads rates are subject to four constraints:

Revenue Adequacy Constraint – A railroad's total revenues may not exceed its total costs, including cost of capital. If total railroad revenues total railroad costs, the carrier is "revenue adequate", and carriers should not be permitted to charge rates that would result in excess of those required to achieve "revenue adequacy."

Management Efficiency Constraint – Under this constraint, captive shippers are protected from paying rates to compensate carriers for management inefficiencies. If a shipper can demonstrate that its rate could be lowered and the railroad still achieve revenue adequacy by correcting inefficiencies in its operations or in the pricing of other traffic, the managerial efficiency constraint would be applied to reduce the shipper's rate.

Stand-Alone Cost Constraint – A key feature of CMP is that a shipper should not bear the costs of any facilities and services from which it derives no benefit. The constraint on rates from this form of cross-subsidization is the "stand-alone cost" test:

"This test is used to compute the rate a competitor in the market-place would need to charge in serving a captive shipper or group of shippers who benefit from sharing joint or common costs. A rate level calculated by the SAC methodology represents the theoretical maximum that a railroad could levy on shippers without substantial diversion of traffic to a hypothetical competing service. It is, in other words, a simulated competitive price.

"… The stand-alone cost, as we define it here, approximates the full economic costs, including a normal profit, that need to be met for an efficient producer to provide service to the shipper(s) identified. This cost calculation produces a competitive price standard against which actual rates can be compared" (Coal Rate Guidelines, pp 528-529).

It should be noted that this constraint does not mean that the rate ceiling is represented by the cost that would be incurred by a hypothetical competitor to provide the infrastructure, equipment and facilities necessary to carry only the traffic for which the rates are in dispute. Under the principle of grouping, the stand-alone cost would include the costs (and offsetting revenue) of any other traffic that would use the stand-alone network.

Phasing Constraint – Under this constraint, permissible rate increases on coal traffic could be phased in rather than implemented immediately if the shipper can demonstrate that the increases would cause "significant economic dislocations which must be mitigated for the greater public good."

Constrained Market Pricing has been applied in all the major coal cases to determine maximum rate reasonableness since its adoption in 1985.

16.4 Maximum Rate Standards For Small Volume Shipments

Subsequent to the adoption of Coal Rate Guidelines in 1985, the Commission turned its attention to the development of maximum rate standards for non-coal traffic (i.e., shipments of small volumes, infrequent shipments, and shipments with multiple origins and destinations), and opened a rulemaking proceeding covering this type of traffic in May, 1986 (Ex-Parte 347 (Sub. No. 2) – Rate Guidelines – Non-Coal Proceedings).

The Commission indicated that while the economic principles of Constrained Market Pricing were equally applicable to all commodities, the stand-alone cost constraint would be expensive to apply and might place too great a burden on “small” shippers in the form of litigation costs. It therefore sought comments on the application of CMP in non-coal proceedings.

In the end, the STB in 1996 adopted a simplified, “rough justice” approach: benchmarks were to be used in conjunction as a guide to rate reasonableness.

Revenue Shortfall Allocation Method (RSAM) Benchmark – This benchmark measures the uniform mark-up (revenue/variable cost ratio) that would be needed from every shipper of potentially captive traffic (i.e., traffic with a revenue/variable cost ratio of greater than 180%) in order for the carrier to recover its constant costs.

Revenue/Variable Cost (Comparable Traffic) Benchmark – This benchmark measures the revenue/variable cost ratio on traffic with a revenue/variable cost ratio of greater than 180% that involves similar commodities moving under similar transportation conditions as the traffic at issue. The decision declares that this benchmark “provides a means of reflecting demand-based differential pricing principles.” The Board recognized that the test is “crude” because the comparison traffic is not likely to have precisely the same degree of demand elasticity as the issue traffic. [Compare the formula for calculating a competitive live rate at sec. 133 of the CTA.]

Revenue/Variable Cost (All Traffic) Benchmark – This test compares the revenue to variable cost ratio for all traffic with a revenue/variable cost ratio of 180% to the revenue/variable cost ratio for the issue traffic. The purpose of this test, according to the STB, is to ensure that the traffic at issue is not bearing without good cause a disproportionate share of meeting the railroad’s revenue requirements relative to the share borne by other demand inelastic traffic. The rail carriers unsuccessfully appealed the decision, the Court dismissing the appeal because there was no actual case before it. (A.A.R. v. STB, 46F3rd 942 (D.C.C. 1998))

17.0 Consolidations

The Canadian regulatory system does not concern itself with consolidations, at least not in railway-specific legislation. Canada has long had an intensively consolidated system with only two major transcontinental railways. In the United States, the consolidated provisions have enabled the STB to exercise a critical role in the shape that consolidations – if permitted at all – are to take. In fact, consolidation proceedings and consolidation rulemaking have been the battlegrounds on which most regulatory ground is being won or lost by shippers and carriers today.

The following activities may be carried out only with the approval and authorization of the STB: (1) consolidation or merger of the properties or franchises of at least two carriers into one corporation for the ownership, management, and operation of the previously separately owned properties; (2) a purchase, lease, or contract to operate property of another carrier by any number of carriers; (3) acquisition of control of a carrier by any number of carriers; (4) acquisition of control of at least two carriers by a person that is not a carrier; (5) acquisition of control of a carrier by a person that is not a carrier but that controls any number of carriers; and (6) acquisition by a rail carrier of trackage rights over, or joint ownership in or joint use of, a railroad line (and terminals incidental to it) owned or operated by another rail carrier (ss. 11323(a)).

The Board is required to approve a railroad consolidation proposal if it is found to be "consistent with the public interest" (ss. 11324(c)). (More liberal standards and procedures apply when the proposal does not involve at least two Class I carriers.)

Several sources help define the "public interest" standard.

The Act itself requires the Board to consider five factors in determining consistency with the public interest:

1. the effect of the proposed transaction on the adequacy of transportation to the public;
2. the effect on the public interest of including, or failing to include, other rail carriers in the area involved in the proposed transaction;
3. the total fixed charges that result from the proposed transaction;
4. the interest of carrier employees affected by the proposed transaction; and
5. whether the proposed transaction would have an adverse effect on competition among the carriers in the affected region or in the national rail system (ss. 11324 (b)).

The STB is also guided in its consideration of consolidations by the national rail transportation policy, a primary goal of which is to "ensure the development and continuation of a sound rail transportation system with effective competition among rail carriers and with other modes" (ss. 10101(1)).

The STB is required to consider the policies embodied in the antitrust laws in its analysis of the public interest. It does so by balancing any anticompetitive effects of consolidations against anticipated transportation benefits. It has the authority to disapprove consolidations which would not violate the antitrust laws and to approve consolidations which would violate antitrust laws. Its antitrust analysis is particularly important because the statute exempts approved transactions from the antitrust laws
(s. 11321).

Finally, in its evaluation of rail considerations, the STB also: (1) must make special public interest findings where a guarantee or assumption of payment of dividends or fixed charges or an increase of total fixed charges is involved; (2) may require inclusion of other rail carriers in the area involved in the transaction; and (3) must subject proposed transactions to environmental (including safety) review.

In 1981, the ICC issued a policy statement clarifying how it would incorporate the various public interest considerations in its evaluation of consolidation proposals. It announced that it would

perform a balancing test weighing the potential benefits to applicant and the public against potential harms to the public (Railroad Consolidation Procedures, 363 I.C.C. 784 (1981)).

The pronouncement identified a number of specific public benefits that may arise from rail consolidations. For example, public benefits may include operating efficiencies and marketing opportunities which strengthen the consolidated carrier financially and better enable it to provide adequate service on demand. Other benefits identified in the pronouncement are operating efficiencies from elimination of duplicative facilities and the availability of more efficient routings. The policy statement also reflects an understanding that consolidations may be the only feasible way for carriers to enter new markets and that anticipated competitive responses to a consolidation by other carriers may multiply the public benefits.

The Board's analysis of potential harm focuses on reductions in intra- or intermodal competition and harm to essential services provided by competing carriers. In this regard, intramodal traffic diversions may reflect the benefit of improved service, or may indicate harm if they are due to the exercise of market power, the ability to achieve monopoly profits, reduced competition, or harm to essential services. Intermodal diversion may signal beneficial improvements in rail service sufficient to offer former truck customers a more competitive, fuel-efficient alternative. Such diversions may also reduce the adverse environmental effects of highway traffic.

The ICC Termination Act classified consolidation transactions into four groups: major, significant, minor, and exempt (s. 11323). A significant transaction is one that is of regional or national transportation significance, but does not involve the control or merger of two or more Class I railroads. A minor transaction involves more than one railroad and is not major, significant or exempt. Exempt transactions are those which the STB has determined do not require prior review and approval from the perspectives of the rail transportation policy.

Major transactions involve the control or merger of two Class I railroads. Applicants must submit detailed evidence regarding the transaction's effects on carrier operations, costs, financial attributes, and on the environment.

An important aspect of the STB's rail consolidation procedures is the public nature of the proceedings. In reviewing major transactions, the Board typically receives comments and evidence from a large number and variety of parties, including shipper and other business groups, labour organizations, state and local government bodies, and other railroads. These comments cover a broad range of issues touching on public and private interests, including many not specifically identified in the statute or the Board's regulations. The Board allows extensive time for the consideration of these comments.

The STB has used its approval power to proactively shape transactions. In its general policy statement for major transactions, it stated as follows:

> Conditions. (1) The Board has broad authority to impose conditions on consolidations, including those that might be useful in ameliorating potential anticompetitive effects of a consolidation. However, the Board recognizes that conditions may lessen the benefits of a consolidation to both the carrier and to the public. Therefore, the Board will not normally impose conditions on a consolidation to protect a carrier unless essential services are affected and the condition: (i) is shown to be related to the impact of the consolidation; (ii) is designed to enable shippers to receive adequate service; (iii) would not pose unreasonable operating or other problems for the consolidated carrier; and (iv)

> would not frustrate the ability of the consolidated carrier to obtain the anticipated public benefits. Moreover, the Board believes that indemnification is ordinarily not an appropriate remedy in consolidation proceedings . . . . (49 CFR 1180.1)

Generally, the Board requires that a condition must address the effects of the proposed transaction, should be tailored to remedy those specific effects, and that it should not be designed to put its proponent in a better position than it had before. The Board frequently has employed its power to condition approval of a rail combination on the performance of a variety or remedial actions by the applicant carriers. Typical conditions include:

- grants of trackage and/or haulage rights by the applicant railroads for the purpose of addressing reductions in the competitive transportation alternatives available to shippers in particular markets;

- labour protective conditions for employees of the applicant railroads who are adversely affected by the transaction;

- actions to identify or ameliorate any environmental harms found to be caused by the transaction; and

- safety measures.

[Current indications are that a major shift in United States regulatory policy is imminent, largely triggered by the sharp drop in the number of Class I carriers in recent years and by concerns with whether consolidations have been delivering what the applicants have said they would.

At the beginning of October 2000, the STB issued a Notice of Proposed Rulemaking proposing new rules for major railroad mergers and consolidations that would significantly increase the burden on applicants to demonstrate that a proposed transaction is in the public interest (STB Ex Parte No. 582 (Sub-No. 1)). In particular, the new rules would require applicants to show that the transaction would enhance competition and would require much more accountability with respect to claimed merger benefits and service.

The STB advised that it proposed to make a major shift from the pro-merger approach that has guided merger decisions for the last twenty years since there is no longer the pressing need Class I railroads once had to consolidate their operations to reduce excess capacity. That rationalization has largely been accomplished. The Board also emphasized that recent consolidations have occasioned significant transitional service problems that have harmed shippers and delayed the realization of anticipated merger benefits.

At a minimum the board “would require applicants to propose specific remedies to keep open major existing gateways, retain build-out and build-in options, and preserve the opportunity of shippers in the so-called bottleneck situation to obtain a contract rate for one segment of a movement in order to separately challenge a rate for the remainder of the movement.” The Board noted that it was no longer appropriate to limit the focus of its conditioning power to preserving competition and essential services, and that it would impose conditions as necessary to mitigate or offset all types of harm to the public interest, including conditions that would enhance competition.

The proposed rules are currently under review and reformulation. The STB has announced that its new rules would be finalized and issued in June of 2001.]