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## **EFFICIENCY AND EQUITY IN THE PROVISION OF FREIGHT RAILWAY SERVICE**

In 2007, Parliament passed Bill C-11<sup>1</sup>, which entailed, among other things, a substantial revision to the statement of national transportation policy.<sup>2</sup> This amendment is welcome in the sense that it promotes the value of competitive, economic and efficient transportation services, all attributes for which the Canadian polity strives, as best articulated by its national competition policy.<sup>3</sup>

As of writing, the House of Commons had passed Bill C-8<sup>4</sup>, addressed some outstanding rail regulatory issues that have appeared in previous bills. These simple changes, while welcome for many shippers, as well as other rail users, do not address the fundamental need for competition in the freight railway sector. There are many reasons why the benefits of competition that are so taken for granted in virtually every other industrial sector should be applied to rail freight transportation. Among those reasons, policymakers can look to the benefits of allocative or productive efficiency, as well as equity and fairness, to support fundamental change in a way that brings the benefits of competition to rail users.

Railways seek, and for a variety of reasons should seek, the greatest share of the overall freight transportation market (i.e., all modes) that is available. Increasing returns to density in the railway sector prove

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<sup>1</sup> *An Act to amend the Canada Transportation Act and the Railway Safety Act and to make consequential amendments to other Acts*, Royal Assent June 23, 2007

<sup>2</sup> *Canada Transportation Act*, c. 10, s. 5, as am.

<sup>3</sup> *Competition Act*, RSC 1985, c.C-34, as am.

<sup>4</sup> *An Act to amend the Canada Transportation Act (railway transportation)*, January 28, 2008

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this out. As noted elsewhere<sup>5</sup>, this allocative efficiency allows the carriers to produce at lower marginal costs, thus realizing the benefits of productive efficiency. Rail shippers care, or should care, about both types of efficiency. Transportation policymakers also should care, for the same reasons those concerned about competition policy care.

At the same time, there is a national interest in equity and fairness between participants in the broader economy. As an export nation, we can ill afford any restriction on output or imbalances in the allocation of total surplus that favours rail carriers over large resource producers shipping products to foreign markets, especially to the extent now present. Nor can we afford that kind of imbalance in domestic markets for purchasers of products laden with unnecessary delivery costs occasioned by excessive rail rates, inferior service or restricted output. In achieving this result, there are two additional benefits: reduction in harm to the economy and reduction in the economic rent appropriated by the carriers due to the use of market power.

Of course, carriers may not be pleased with restrictions on the size of the total surplus that ends up in their hands. Notwithstanding this self-evident truth, there are many reasons why we must.

### **The Timing is Good**

Federal freight railways operating in Canada are doing well and have been doing well for some time. Carriers have benefited from a reduction in regulatory burdens, unimpeded ability to abandon uneconomic lines, readily available access to capital and rapid realization of the efficiencies of consolidation. In addition, most pricing and output decisions are largely out of the hands of regulators.

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<sup>5</sup> McCullough, undated, US Railroad Efficiency: A Brief Economic Overview, at <http://www.trb.org/conferences/railworkshop/background-McCullough.pdf>, accessed December 24, 2007, citing Ivaldi and McCullough (2001), "Density and Integration Effects on Class I U.S. Freight Railroads." *Journal of Regulatory Economics* 19:2. 161-182

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However, those gains have been built on the backs of a category of shippers who are now largely paying for the systems of CN and CP alike. But gains obtained in that manner are not justifiable on either efficiency or fairness grounds. The competitive balance between captive shippers and Canada's two main railways must be adjusted to allow for a less burdensome toll on that class of shippers in particular.

The timing is good because these carriers are financially healthy, despite increased fuel costs and a weakening economy. Their other costs are not rising and carrier and external projections demonstrate carriers have little fear of the state of the broader economy.

#### **Current Remedies Inadequate to Achieve Efficiency and Equity**

In retrospect, even the introduction of shipper remedies over the past two decades has not resulted in a reduction of carrier ability to extract from captive shippers the contributions to their constant costs sufficient to address their revenue and capital needs. If anything, the opposite is true. The evidence points to over-recovery, both in terms of costs of capital and contribution to constant costs. Obtaining sufficient capital is not the worry it was when shipper remedies were introduced, and the performance of the two carriers in this regard has left those concerns far behind. Further, total contributions have risen far beyond constant costs, and for captive traffic the average is even greater.

The *Transport Act* (1938), the *National Transportation Act* (1967), the *National Transportation Act, 1987* (in force in 1988) and the *Canada Transportation Act* (1996), in conjunction with the privatization of CN, all contained important elements of economic deregulation for the rail freight transportation system. We have moved from a system of price and service regulation to two private, unregulated natural monopolies. In some measure, this has been a positive development, not only for the railways, but for Canadian taxpayers as well.

Despite shipper remedies, rail carriers now have greater ability to use existing market power to consolidate gains and extract monopoly

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rents than ever before. During the course of deregulation, consolidation in the rail industry has also led to few participants, and the regulatory environment that remains has made entry difficult. Unfortunately, where possible, railways have taken advantage of their market power to the detriment of their customers' needs. The exercise of railway market power has been the subject of many reports, including those presented to the *Canada Transportation Act Review Panel* (2000/2001) during which shippers from numerous industries expressed the many ways in which this market power was being exercised. The experience of captive shippers is no different today than it was eight to ten years ago: inadequate service (output) or regularly increasing prices or both.

The deregulation of Canadian railways has been driven by many factors – railway management, intermodal competition, U.S. deregulation – and, to a certain degree, has paralleled what has and is happening in other natural monopolies such as the telecommunications industry, pipelines, and electrical energy transmission. In all these network service sectors, major regulatory changes have been or are being made to introduce the benefits of a more competitive environment – lower costs, improved service and greater efficiencies. Similarly, in all of these sectors, the regulation of monopoly power has been the most significant issue to overcome. But, it has occurred, whether to achieve the available efficiencies or over equity or fairness concerns or both.

The difficulty of deregulating a natural monopoly's market power is not surprising: indeed, the fact of a natural monopoly is to admit that the market will not work to constrain the ill effects of downstream conduct that leads to regulation in the first place. Even upstream concerns over capitalization requirements lead to regulatory oversight. Once capitalization concerns are addressed by the market, however, the temptation has been to deregulate ahead of adequate market preparation. That was the theory behind shipper (customer) protections invoked in the 1987 legislation in the form of regulated interswitching, competitive line rates and final offer arbitration. That is, policymakers hoped that the introduction of these remedies would offset carrier market power once pricing and output regulation was

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eliminated. But, competitive network access (running rights) to offset carrier market power has been unsuccessful, but only because it has never been granted as a remedy.

One very difficult challenge has been the overwhelming shipper dissatisfaction with price and service during deregulation. In large measure, the dissatisfaction is expressed by businesses involved in the shipment and export of commoditized products that are the mainstays of rail carrier service. Some, perhaps many, Canadian export industries are becoming less competitive in an increasingly globalized trading world where Canada has been a major participant. Regulatory remedies have simply not been effective to constrain railway market power.<sup>6</sup> As a consequence, there is an imbalance between the wealth generated by shipping commodities, on the one hand, and transporting those commodities, on the other hand.

The exposure of natural monopolies in other industries to competition is instructive. For example, in telecommunications, prices to consumers have come down substantially and the telecommunications enterprises that were originally monopolies have generally flourished and are more efficient. Predictions of dire consequences by these monopolies if they were forced to compete did not materialize. Capital reinvestment did not dry up. Instead, the normal flux of the competitive process required management to concentrate on survival, cutting costs, improving service, product differentiation, etc. Instead of limiting entrants, policymakers are now looking at expanding spectrum to allow more wireless market participants. And incumbents have enjoyed another advantage: those who are dominant have enjoyed a head start in competing with new entrants.

Freight railways operating in Canada enjoy significant volumes of business that are completely captive to rail, and often captive to one

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<sup>6</sup> See Tougas, "Shippers and Railroads: A Canadian Perspective" (originally entitled "Qualitative Aspects of Price and Output Regulation of Federal Freight Railways in Canada"), Journal of Transportation Law, Logistics and Policy, June 2006; and, "Responding to the Market Power of Federal Freight Railways," in Competition as a driver of change: Proceedings of the 41st Annual Conference of the Canadian Transportation Research Forum, May 2006

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railway only. There are several examples of captive customers in coal, forest products, grain, etc.

### **The Need For Rail Competition**

The ability of rail carriers to regulate their own prices, output and service offerings has shifted burdens to bulk shippers that are captive to single-supplier rail service. In essence, captive shippers are paying for the constant costs of these railways; meanwhile, these same shippers contend with intense international competition for their commodities while the supply of rail services is monopolized. The friction of the marketplace that would normally put downward pressure on rates and upward pressure on service and innovation is lacking in the circumstance.

Regulatory change over the past few decades has not resulted in a reduction of railway market power over captive shippers. The *Canada Transportation Act* (1996) facilitated the success of CN upon privatization by providing prospective shareholders with a railway that could price its services to captive shippers with few restrictions. These railway shareholders have been well rewarded and the privatization of CN has been a great success. CP has benefited, too, from a regulatory environment that suspends or restricts shipper ability to bargain. As a result, there is no question about the adequacy of the revenues of these two carriers in particular.

During the course of the 1990s and the beginning of this decade, captive resource sector shippers in Canada saw their international competitiveness decline in the face of increasing international competition for the supply of their products. This occurred in an environment of railway pricing that was unresponsive to “market” signals because there were none: there is no market in which carriers compete for the supply of their services to this class of shippers. The “competition” faced by rail carriers in those circumstances is indirect at best; that is, they look through their “markets” to their captive customers’ markets to make sure those customers are not priced out of the commodity market altogether. In this manner, the carrier determines who gets to keep the greatest share of the total surplus,

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rather than the flux of the market. The lack of restraint of carrier market power means, in essence, that industrial policy favours the income of rail carriers over their customers, or, otherwise said, rail carrier income distribution to shareholders is to be preferred over income distribution to resource industries.

On the other hand, where rail carriers have to compete to retain their customers (primarily due to intermodal competition, but also in the face of intramodal competition), those same rail carriers accept lesser contributions to constant costs, by definition. That is like saying the higher the contributions from captive traffic, the more a rail carrier can afford to compete for lower contribution traffic. That is the net effect of ineffective shipper remedies: an imbalance that is inequitable in effect and inefficient as a means of getting the right resources at the right prices to the right customers, an overall goal of competition policy that has found its way into the new statement of national transportation policy.<sup>7</sup>

Adding to the difficulty, where captive shippers' markets have thrived in recent years, rail carrier rate expectations have increased as well. Those are not markets that are working the way one would expect them to work: in this faulty "look through" environment, instead of prices going down, they go up; instead of service going up, they go down.

Further, despite record commodity prices, the lack of a competitive rail system in Canada has not uniformly improved the overall global competitiveness of the producers of these commodities. At the very least, each of these producers expects to receive the benefit of competition in the provision by its suppliers of the various goods and services that are inputs to the exploitation of their commodities.

### **Bringing the Benefits of Competition to Rail Freight Services**

The Government of Canada has been active in addressing the concerns of many shippers. In June 2007, Parliament passed

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<sup>7</sup> Note 2, *supra*.

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legislative amendments in Bill C-11<sup>8</sup> that, among other things, amended the statement of national transportation policy and reintroduced reviews of transportation mergers and acquisitions. The review of transportation undertakings is not a new concept. All such mergers were reviewed by the former National Transportation Agency before the 1996 amendments to the *Canada Transportation Act*. The effect of Bill C-11 is more like restoring regulatory oversight to prevent a reoccurrence of a situation like the acquisition of BC Rail by CN, which was deprived of a review to determine if it accorded with Canada's national transportation policy or the failed CN/BNSF merger that received no review in Canada whatsoever, requiring Canadian shippers to make their case before the U.S. Surface Transportation Board even though the proposed transaction affected Canadian shippers in a dramatic way. However, the mechanisms for review under the new Bill C-11 provisions are in fact new and reasonably complex. The process is a combination of administrative and quasi-judicial processes that ultimately may be reviewed and decided at the political level. Whether this new system acts to constrain or permit further consolidation remains to be seen.

The language of the new transportation policy underscores that the national transportation system is there "to serve the needs of its users, advance the well-being of Canadians and enable competitiveness and economic growth in both urban and rural areas throughout Canada". The policy declares "that a competitive, economic and efficient national transportation system that ... makes the best use of all modes at the lowest total cost is essential". This new policy statement is consistent with the purposes of competition policy, which are to "maintain and encourage competition in Canada in order to promote the efficiency and adaptability of the Canadian economy, in order to expand opportunities for Canadian participation in world markets," etc.

It is hard to imagine two more congruous policy statements. Parliament has spoken, yet carrier market power remains virtually unconstrained in the areas where it counts most: price, output and

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<sup>8</sup> Note 1, *supra*

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service. In order to address some outstanding irritants, particularly for smaller shippers, another Bill was introduced.

Bill C-8,<sup>9</sup> which has been debated before the Standing Committee on Transport, Infrastructure and Communities (SCOTIC) and was in the Senate at time of writing, would address several railway market power issues that are designed to assist some, if only few, shippers. Some of the relevant provisions include: allowing the adjudication of price increases for ancillary (non-rate) charges at the Canadian Transportation Agency; the elimination of the need for a shipper to demonstrate that it would suffer substantial commercial harm upon the exercise of certain, if little-used, remedial statutory measures; Agency-conducted mediation for certain types of disputes; and, multi-party final offer arbitration for shippers with common matters.

Further, the Minister of Transportation announced<sup>10</sup> a railway service review to start 30 days after Bill C-8 is passed, which will no doubt address the many complaints he advised the SCOTIC he had been hearing from shippers about CN and CP over the previous year.

These changes are largely beneficial and the Government of Canada should be commended for both hearing the concerns and addressing them. The changes have not, however, addressed the fundamental need for competition in the freight railway sector. The remedies themselves are unchanged. Interswitching distances are far too short to bring meaningful competition between rail carriers. Competitive line rates have been declared not to work by government panel reviews and shippers alike. Running rights have yet to be granted to anyone by the Agency. Final offer arbitration is decidedly the best way of resolving disputes between a carrier and a shipper, but its value has eroded over time for a variety of reasons, each of which should be addressed. That is the entire list of remedies.

Combined with grain, the resource sector accounts for more than 50% of CN's and CP's revenue and most of its profits. Yet, their capital investment programs are increasingly directed toward their least

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<sup>9</sup> *An Act to amend the Canada Transportation Act (railway transportation)*

<sup>10</sup> Transport Canada, News Release H210/07, October 29, 2007

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profitable and most competitive sector of railway business – intermodal traffic. Both CN and CP have demonstrated that where they must compete against each other and against other carriers, they do so. Not surprisingly, competition is beneficial to those served by several rail carriers. The challenge lies in creating competition where only one carrier serves a shipper.

The best efforts to create competition through tweaks of the existing legislation will not result in the benefits of competition that Canadian industry requires and should expect. It is not reasonable to expect that, with Canada's geographically-dispersed shippers, remote locations and great distances, competition between railways will naturally arise. No one is going to build more railways to compete against the carriers in those areas where they have captive shippers.

The case for more competition in the provision of rail services is simply that it is in Canada's best interests for industry to realize the benefits of competition generally, that it is efficient to do so and that the demands of equity and fairness dictate that rail carriers should not be preferred over those who are captive to rail.

In a modern economy, competitive market forces bring about the best and most efficient allocation of resources in the form of high quality goods and services at prices closely coupled to cost, innovation and dynamism. All Canadians expect market forces to provide them with these benefits. Unfortunately, these benefits (and the attributes of competition) are noticeably absent from the provision of rail services to captive shippers. That is why we must allow for a correction to those situations where there is no competition or the current level of competition is ineffective.

There are ways to achieve the goals set out in the statement of national transportation policy that deserve our policymakers' very best attention.

Doing nothing will not protect Canada's ability to participate in global commodity markets, which are very closely associated with the transportation of goods from captive shippers (bulk resources, in

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essence) in the face of increasingly volatile markets. It would also seriously imperil Canada's international trade position as an exporter to diverse markets.

The tweaks to legislation of the past 20 years, including those in Bill C-8, are helpful to some, but not all, captive shippers. There is no question that further changes are needed to existing shipper remedies. Among other things, interswitching limits should be extended, CLR's should be revised to eliminate connecting carrier concurrence and final offer arbitration should be extended to apply to movements originating in Canada regardless of destination. These mechanisms are vital to curtail railway market power, but they are insufficient.

What is needed is major change. Making the kinds of changes that will bring the benefits of competition to a monopoly environment represents a significant policy challenge but not one that is unfamiliar to Canadian policymakers. The rail transportation sector must be viewed in light of the objective to allow Canadian industry to compete in the continental and global value chains that exist in several industrial sectors that make up the majority of rail shipments. The place to start is by providing a policy framework that allows rail rates to be set on the basis of cost, which is the essential hallmark of competition. This will merely replicate what a competitive market would do, and no more.