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CAPTIVE REGULATORS, CAPTIVE SHIPPERS: THE LEGACY OF MCCARTY FARMS

Anthony Johnstone*

Montana has more than five thousand farms growing grain and one railroad shipping it.1 In a typical year Montana produces 150 million bushels of wheat (approximately 500,000 farm trucks), ships 140 million bushels out of state (approximately 50,000 railcars or 450 110-car grain shuttle trains), and exports 100 million bushels from terminals in the Pacific Northwest (approximately fifty 62,000 ton freighter ships).2 The value of this volume of grain depends on its movement to national and world markets beyond Montana’s borders. Transporting it from the high plains to these markets requires railroad service to the extent that more than 97% of wheat shipments out of Montana travel by rail.3 Without competitive transportation alternatives to rail, or competitive railroad alternatives to the dominant statewide carrier, Montana’s grain producers, and the grain elevators that intermediate between the producers and the railroad, are “captive shippers.”

By definition, the prices offered to captive shippers by a railroad monopoly are not effectively constrained by market competition. Instead, if captive shippers are to have any protection at all from a railroad’s potential abuse of monopoly power, laws must fill the gap left by competition’s ab-

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sence. For more than a century, those laws—laws that set the terms under which Montana-grown grain travels to market—have been administered by a single federal regulatory agency in Washington, D.C. This centralized regime began in 1886 when the United States Supreme Court struck down an Illinois law regulating rates on an interstate railroad, suggesting that “regulation can only appropriately exist by general rules and principles, which demand that it should be done by the Congress of the United States under the Commerce Clause of the Constitution.”

The next year Congress enacted the Interstate Commerce Act, establishing the Interstate Commerce Commission and requiring that “[a]ll charges made for any service rendered or to be rendered in the transportation of passengers or property” by railroad “shall be reasonable and just; and every unjust and unreasonable charge for such service is prohibited and declared to be unlawful.”

The development of the Interstate Commerce Act, like that of its contemporary—the Sherman Antitrust Act of 1890—is intertwined with the development of agricultural production in the United States. During the early decades of the Interstate Commerce Commission, its fortunes paralleled those of the agricultural interests that supported its creation, reaching “the peak of the Commission’s power and prestige” in the decade preceding the First World War. As farmers’ political power waned and other shippers’ transportation options multiplied, however, the Commission became increasingly dependent on railroad support. By mid-century the railroads had embraced the Commission with an “attitude of . . . satisfaction, approbation, and confidence.” In time, the Interstate Commerce Commission showed that regulators, as well as shippers, could be captured by railroads.

The relationship among the Commission, the railroads, and the shippers took another turn 30 years ago with the deregulation of the transportation industries, as Congress reoriented the Interstate Commerce Commission to protect railroads in addition to shippers. Part I of this article describes the circumstances behind this regulatory shift and the regime it produced. Part II explains both the development and failure of the new regime in a case brought by a group of Montana wheat and barley farmers, McCarty Farms, Inc. v. Burlington Northern, Inc. Part III describes the termination of the Commission and the attempts of the newly created Sur-

10. Id. at 473.
face Transportation Board to correct the regulatory failure of McCarty Farms. Part IV explains the impact of the new regime on railroads and grain shippers, and discusses procedural lessons from McCarty Farms that may guide future reforms of the Surface Transportation Board and other regulatory institutions.

I. RAILROAD REVITALIZATION BY REGULATORY REFORM

Ninety years after the enactment of the Interstate Commerce Act, the financial condition of the railroad industry “was poor and seemingly getting worse.”11 The share of inter-city freight carried by railroads shrunk from 75% to 38% fifty years later.12 The industry’s rates of return fell far below those of other industries, and capital-starved major Class I railroads faced more than $4 billion in deferred maintenance expenses and delayed capital expenditures.13 Several northeast railroads had recently emerged from bankruptcy as the Consolidated Rail Corporation (Conrail), 11 of the 36 Class I railroads were earning negative returns on investment, and three—including the Milwaukee Road running through central Montana—had entered bankruptcy.14 Still, several western railroads other than the Milwaukee Road were relatively healthy compared to their eastern counterparts at the time.15 Meanwhile, truck and barge traffic benefited from federally subsidized highways and waterways and from far less regulation.16 Rail regulation under the Interstate Commerce Commission complicated railroads’ attempts to reduce prices to meet the competition and to shift services to meet changing demand.17

Congress responded in 1976 with the Railroad Revitalization and Regulatory Reform Act (4R Act).18 The 4R Act’s purpose was “to provide the means to rehabilitate and maintain the physical facilities, improve the operations and structure, and restore the financial stability of the railway system of the United States” through a policy that included rate deregulation in competitive markets.19 The 4R Act accomplished deregulation primarily by repealing the Interstate Commerce Act’s regulation of “all charges” and replacing it with “just and reasonable” rate regulations only when the Com-

12. Id.
13. Id. at 10–11.
14. Id. at 11.
17. Id. at 12.
19. Id. at 33.
mission found the railroad to have “market dominance.” The 4R Act promoted financial stability in the industry by requiring the Commission to “make an adequate and continuing effort to assist” railroads in earning revenue levels that are “adequate under honest, economical, and efficient management to cover total operating expenses, including depreciation and obsolescence, plus a fair, reasonable, and economic profit or return (or both) on capital employed in the business.”

Four years later, Congress observed that, without additional action, the “failure to achieve increased earnings within the railroad industry will result in either further deterioration of the rail system or the necessity for additional Federal subsidy.” Based on these findings, Congress followed the 4R Act with the Staggers Act. The Staggers Act required the Commission to consider revenue adequacy in regulating rates. It also created a safe harbor from a finding of market dominance, and thus rate regulation, based on the ratio of a railroad’s revenues to its variable costs.

II. THE STORY OF McCARTY FARMS

A few weeks before President Carter signed the Staggers Act into law, a class of 10,000 Montana farmers and grain elevators sued Burlington Northern in the McCarty Farms case. The farmers alleged that the railroad charged them unreasonably high freight rates for wheat shipments from Montana to port terminals in the Pacific Northwest over the preceding two years, in violation of the Interstate Commerce Act’s requirement that interstate shipping rates remain “reasonable.” Thus began the case’s 18-year “crawl through the legal system.”

At the case’s outset, the parties agreed the Interstate Commerce Commission (ICC) had exclusive jurisdiction to determine the reasonableness of the freight rates, but the plaintiff class included both grain elevators who paid freight rates directly and farmers who did not transact directly with the railroad. Burlington Northern objected that the farmers lacked standing to challenge rates they did not pay. As a matter of antitrust law under the

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23. Id.
Clayton Act,\textsuperscript{30} to avoid “a serious risk of multiple liability for defendants,” indirect purchasers like the farmers could not recover from the railroad if it was also liable to a direct purchaser like the grain elevator.\textsuperscript{31} However, the district court declined to apply this “indirect purchaser” rule to a rate case because it could allocate reparations for unreasonable rates between the direct and indirect shippers already included within the plaintiff class.\textsuperscript{32}

With these threshold questions resolved, the district court referred the case to the ICC to determine the reasonableness of the rates.\textsuperscript{33} Then matters got complicated—so complicated, the Commission later conceded, that it relied upon an appendix to recite the procedural history of the case.\textsuperscript{34} The shippers added a claim concerning barley rates to the wheat-rate claim raised in the original ICC complaint, which the Commission split into a separate case, then later consolidated with another case brought by agencies of the State of Montana.\textsuperscript{35} In a pattern that would repeat itself later, the Commission set a moving target of continuously new and revised guidelines, standards, and rules while the cases were pending. In the four years after the Commission consolidated the cases, it reopened them for comment on one set of rate guidelines, held them in abeyance while it worked on another set of rate standards, reopened them again for additional evidence under the new rate standards, and then reopened them for a third time for additional evidence under a revision of yet another set of standards.\textsuperscript{36} Six years after the district court originally referred the case, the Commission tentatively found the wheat and barley rates unreasonable.\textsuperscript{37}

\section{Market Dominance}

The Commission began its analysis of the McCarty Farms claims by examining the railroad’s market dominance: “an absence of effective competition from other rail carriers or modes of transportation” is a prerequisite to finding unreasonable rates.\textsuperscript{38} The market dominance inquiry includes both a qualitative analysis of actual and potential competition and a quantitative analysis of rate levels measured by the revenue-to-variable cost per-

\begin{itemize}
\item \textsuperscript{31} \textit{Ill. Brick Co. v. Ill.}, 431 U.S. 720, 730 (1977).
\item \textsuperscript{32} \textit{McCarty Farms I}, 91 F.R.D. at 491.
\item \textsuperscript{33} \textit{McCarty Farms v. Burlington N. Inc.}, 3 I.C.C.2d 822, 846 (1987) [hereinafter \textit{McCarty Farms II}].
\item \textsuperscript{34} \textit{Id.} at 823.
\item \textsuperscript{35} \textit{Id.} at 846–47.
\item \textsuperscript{36} \textit{Id.} at 847.
\item \textsuperscript{37} \textit{Id.} at 844.
\item \textsuperscript{38} \textit{Id.} at 825 (quoting 49 U.S.C. § 10709(a) (1987) (now 49 U.S.C. § 10707(a) (2000))).
\end{itemize}
If a railroad’s rates result in a revenue-to-variable cost percentage (R/VC) of less than 180%, the railroad lacks market dominance as a matter of law, even if the shipper otherwise shows an overall absence of effective competition. The Commission has called the market dominance finding in general, and the 180% level in particular, “jurisdictional.” The railroad did not contest the jurisdictional R/VC percentage, which the shippers showed to fall between 240% and 250%.

The qualitative competition analysis included four kinds of competition: intramodal (other railroads to the same destinations), intermodal (other means of transport to the same destinations), product (other products the receiver can substitute), and geographic (other destinations the shipper can substitute). The Commission found no effective intramodal competition—given that Burlington Northern owned 91% of the railroad tracks which served 98% of the grain elevators—and had minimal competition from its then-rivals, the Union Pacific, running south from Butte and the Soo Line, running through the extreme northeastern corner of the state. The Commission found slightly more intermodal competition from trucking companies for transport to Lewiston, Idaho, and from barge shipments down the Snake and Columbia rivers. Even with this competition, the Railroad still carried 80% of the grain shipments to Pacific Northwest ports.

Geographically, the shippers showed they could not easily switch markets by diverting most of their grain past their competitors to eastern and Gulf ports. The shippers also successfully argued that their high-protein grains were renowned as the “Cadillac of wheat” for which there was no substitute. Later, due to the complexity and expense of the analysis, the Surface Transportation Board limited the consideration of these kinds of “indirect” competition (in product and geographic markets) to the transported product, the origin, and the destination to which the rate at issue applies.

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42. *McCarty Farms II*, 3 I.C.C.2d at 825 n. 4.
43. *Id.* at 825.
44. *Id.* at 827.
45. *Id.* at 830.
46. *Id.* at 834.
47. *Id.* at 836.
B. Rate Reasonableness

Under the regulatory reform acts, “[i]f the Commission determines . . . that a rail carrier has market dominance over the transportation to which a particular rate applies, the rate established by such carrier for such transportation must be reasonable.” The “Long-Cannon Amendment” to the Staggers Act prescribed factors the Commission must consider to protect captive shippers from subsidizing other shippers by discouraging underpriced railroad services for shippers in competitive parts of the rail network, encouraging recovery of the maximum amount of fixed costs from those shippers under competitive pricing, and keeping a captive shipper from “paying an unreasonable share of the carrier’s overall revenues.”

A countervailing constraint on the reasonableness determination is Congress’s policy, expressed repeatedly in statute, “that rail carriers shall earn adequate revenues.” In testing the reasonableness of the rail freight rates charged in McCarty Farms, the Commission had before it a sample of 282 out of more than 3,000 freight “movements.” While the Commission could not compute the relief owed to shippers based on that record, it did attempt to develop a process for determining the reasonableness of individual rate levels. The Commission considered two options for the rate review: so-called “Coal Guidelines” originally established for large shipments from single origins (such as coal from a mine) and “Non-Coal Guidelines” for smaller shipments from multiple origins (such as grain from elevators dispersed over a farming region).

1. “Coal Guidelines”: Constrained Market Pricing

Constrained market pricing was the Commission’s attempt to “apply[ ] competitive pricing principles to a regulatory framework.” The overall objective of constrained market pricing is for a captive shipper to pay only what is “necessary for the carrier(s) involved to earn adequate revenues,” and for the shipper involved to receive “efficient service.” In plainer

51. Id. at § 10701(a)(3) (1987) (now 49 U.S.C. § 10701(d)) (2000); see also 49 U.S.C. § 10704(a)(2) (2000) (“The Commission shall maintain and revise as necessary standards and procedures for establishing revenue levels for rail carriers providing transportation subject to its jurisdiction under that subchapter that are adequate, under honest, economical, and efficient management, to cover total operating expenses, including depreciation and obsolescence, plus a reasonable and economic profit or return (or both) on capital employed in the business.”).
52. McCarty Farms II, 3 I.C.C.2d at 839.
53. Id.
54. Id. at 839–840.
56. Id.
terms, the rate floor is the minimum price that a railroad needs to stay in business, while the rate ceiling is the maximum price that a shipper needs to pay to cover the costs of the railroad’s service. The Commission also suggested that the revenue adequacy floor might also serve as the ceiling, with the railroads needing to “demonstrate with particularity” why captive shippers should bear the burden of paying higher rates to provide railroads with adequate overall revenues.\(^{57}\) Two concepts, “differential pricing” and “the contestability of markets” provided, in the Commission’s words, “the analytical basis for determining those costs for which a shipper may properly be charged and the extent to which the shipper should bear the costs.”\(^{58}\)

\(a.\) \textit{Ramsey Pricing and Differential Prices}

The economics of railroads pose a dilemma in determining reasonable rates for captive shippers. Railroads enjoy significant economies of scale, scope, and density.\(^{59}\) Economies of scale occur when a firm’s average cost of service declines as its facilities expand, such as a railroad’s ability to run shuttle trains of 110 cars at a lower per-car cost than a single carload, or a trans-continental railroad’s ability to move freight long distances without the cost of multiple interchanges between railroads. Economies of scope occur when a single firm can offer multiple services at a lower cost than multiple firms could, such as a railroad’s ability to transport grain and coal in hoppers, chemicals in tankers, and other freight in container cars without building separate rails for each load. Economies of density occur when a firm’s average cost-of-service declines as its facility’s use increases, such as a railroad’s ability to coordinate several trains on the same tracks.\(^{60}\) These economies have limits and corresponding diseconomies—for example, unwieldy management at too-large scales of production, lack of expertise over too-broad scopes of services, and congestion costs at too-busy densities of traffic—but the Commission concluded “there are at least some production economies in the rail industry.”\(^{61}\)

In economic terms, the consequence of these efficiencies is that the marginal cost of rail service (running one more carload) is less than the average cost (running the carload plus the per-carload share for the car, locomotive, and tracks).\(^{62}\) A railroad can offer an additional shipper service at the relatively low marginal cost of moving the carload from its origin to a destination, but it will offer that additional service only if it can

\(^{57}\) \textit{Id.} at 536 n. 36.

\(^{58}\) \textit{Id.} at 525.

\(^{59}\) \textit{Id.} at 526.

\(^{60}\) \textit{Id.} at 553.

\(^{61}\) \textit{Coal Rate Guidelines, Nationwide,} 1 I.C.C.2d at 531.

\(^{62}\) \textit{Id.} at 526.
cover the associated fixed costs with other revenue. For traditional utilities exhibiting similar economic characteristics, this is not a problem—the power company with an exclusive franchise on delivering electricity to homes without substitute power sources can achieve revenue adequacy by charging all of its customers the average costs of the energy and transmission lines.

A marginal cost below average cost presents a rate-setting problem. Unlike traditional utilities, railroads can face competition from substitute transportation modes that can price below the railroad’s average cost. The task of determining reasonable rates while ensuring revenue adequacy demands some method of differential pricing “because the railroad’s rates for its non-captive service are determined by market forces, while the non-captive service utilizes much of the same facilities.”63 Consider, for example, a railroad that runs from Montana to Idaho and Washington, then along the Columbia River to Portland, Oregon. If the railroad charges only its marginal costs to every shipper, it cannot cover its total costs, cannot survive as a viable business, and thus cannot serve any shipper. But if the railroad charges its average costs to every shipper, it will lose customers at the western end of the line, for whom it is cheaper to truck their grain to the barges (no matter whether it is even cheaper to pay the marginal cost of rail service plus some small share of fixed costs). That loss of business in Washington affects not only the railroad’s revenue, but also the truck-barge shipper that loses access to marginally more efficient rail service and the Montana shipper that now pays higher rates to cover the same fixed costs spread among fewer shippers.

Ramsey pricing offers a partial solution to this problem. Originally a theory developed to determine optimal tax rates, Ramsey pricing charges a higher price to buyers with less elastic demand and a lower price to buyers with more elastic demand.64 Demand elasticity depends upon the buyer’s ability to substitute a different service in response to a price increase. Thus a captive shipper with few service alternatives has relatively inelastic demand, and as a result, will pay more under Ramsey pricing than a shipper with many service alternatives who can, for example, shift to truck-barge shipping when confronted with a price increase for rail service. According to the Commission, “[a]pplied to 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.”65

Unfortunately, the demand elasticity calculations required for true Ramsey pricing are practically impossible to apply to every shipment by a

64. *Coal Rate Guidelines, Nationwide*, 1 I.C.C. 2d at 526–527.
65. *Id.* at 527.
given railroad. Thus the Commission embraced the simpler form of differential pricing already reflected in its jurisdictional limits: the only prices that need to be regulated—and the only prices that can be regulated under the “market dominance” test—are those of captive shippers, who by definition have low demand-elasticity and pay higher prices. High demand-elasticity shippers, who by definition have other shipping options, enjoy lower prices that are closer to the marginal cost. Ideally, “market forces will largely determine the share of the costs to be borne by each shipper.”

Market forces, therefore, already directly determine the share of costs borne by non-captive shippers paying unregulated rates. The share of costs borne by captive shippers, however, is vulnerable to the railroads’ abuse of its monopolistic power in the absence of effective regulation.

b. Contestable Markets and Stand-Alone Costs

The Commission derived the upper limit of reasonable rates from the theory of “contestable markets,” which states that a monopolist will behave efficiently and competitively if a new entrant threatens to take some or all of its markets. Because the entry of a legitimate, new entrant to compete with a dominant railroad like Burlington Northern is nearly impossible, the Commission developed a method to determine “a simulated competitive price.” The method is the “stand-alone cost” (SAC) test, which posits the rate a hypothetical competitor would charge to serve the captive shipper’s route. That model establishes a rate that “represents the theoretical maximum rate that a railroad could levy on shippers without substantial diversion of traffic to a hypothetical competing service.”

Of course, even a hypothetical, new railroad company could not afford to challenge a dominant company if it had to build a railroad immediately to catch up with one built over more than a century. “Existing railroads were built on a piecemeal basis and were not saddled with a need to marshal, in a short period of time, the resources required to construct a rail system the size of [a competing transcontinental railroad].” The Commission accounted for the hypothetical entrant’s disadvantage by excluding these costs of entry and exit from the SAC test, making “market dominant rail traffic contestable in theory” and “eliminating the potential for monopoly prof-

66. Id. at 534.
67. Id. at 528.
68. Id.
69. Id.
The shipper’s hypothetical railroad could exploit all available economies of scale, scope, and density for the most efficient route between its origin and destination, and include groups of other existing shippers to share fixed costs. Beyond requiring shippers to test rate reasonableness by building their own stand-alone railroads, the Commission declined “to prescribe a hard and fast formula for developing and applying SAC.”

SAC testing was not the only constraint the Commission imposed on dominant railroad pricing. Instead, it recommended an eclectic approach to the rate reasonableness determination. “[T]he various constraints contained in [Constrained Market Pricing] may be used individually or in combination to analyze whether the rate at issue is unreasonably high.” Each constraint provides an approach to determining “the extent of unattributable costs to be covered through differential pricing and the portion that can be charged to the shipper involved.”

First, the Revenue Adequacy Constraint makes a ceiling out of the floor of business sustainability and, in particular, requires “that a railroad not use differential pricing to consistently earn, over time, a return on investment above the cost of capital.” The Management Efficiency Constraint then incorporates the Long-Cannon Amendment factors, a test for whether the rate at issue is unreasonably high because the railroad has shifted the cost of inefficiencies to captive shippers. Finally, the Phasing Constraint limits the pace of rate increases to avoid “significant economic dislocations.”

Still, given the lack of guidelines for applying these other constraints, the Stand-Alone Cost Constraint has become the approach “routinely used in rate cases.”

In adopting a Constrained Market Pricing approach to rate reasonableness determinations, several Commissioners expressed concerns about a process that amounted to testing a shipper’s ability to build a hypothetical railroad better than the real railroad its opponents actually operated. The Chairman and others were “both concerned and hopeful that the Commission will afford captive coal shippers adequate access to whatever relevant information they need.” Thus, “[t]he real challenge for the Commission

71. Coal Rate Guidelines, Nationwide, 1 I.C.C.2d at 529.
72. Id. at 543–544.
73. Id. at 546.
74. Id. at 548.
75. Id. at 547.
76. Id. at 536.
77. Coal Rate Guidelines, Nationwide, 1 I.C.C.2d at 541.
78. Id. at 546.
80. Coal Guidelines, Nationwide, 1 I.C.C.2d at 549 (Taylor, Chairman, commenting); see also id. (Simmons, Commr., commenting) (“captive coal shippers must be granted the reasonable discovery of
will be to translate these new guidelines into fair and efficient outcomes on the individual cases that will be reviewed.”

These same concerns motivated an appeal by coal shippers of the *Coal Guidelines*, in which the Third Circuit rejected various challenges under the Administrative Procedure Act to the guidelines themselves, but declined to consider how the guidelines might be applied in particular cases. Judge Becker, who dissented on the grounds that the Commission’s Revenue Adequacy Constraint was arbitrary, capricious, and contrary to law, also agreed with the shippers about the possibility “that rate challenges will be frustrated by the complexity of the Commission’s inhospitable rules and procedures.” Although Judge Becker found the Stand-Alone Cost Constraint tolerable as a “well reasoned form of regulatory experimentation,” he worried that “the protesting shipper is required to ‘assume a railroad’—no mean task,” and a task that smaller shippers may be unable to meet. “The Interstate Commerce Act was not passed as a full employment bill for economists; it provides a procedure to shippers for challenging railroad rates.” The court gave the Commission the benefit of the doubt on the issue of whether that procedure, and the discovery rules on which it depends, would operate to fulfill the Act’s original goals. “Time will tell,” Judge Becker concluded in dissent, “whether our confidence has been justified.”

2. Alternative Methods of Reviewing Rates

Shortly after the Third Circuit upheld the *Coal Guidelines*, the Commission took note of the cost concerns surrounding the “assume a railroad” Stand-Alone Cost approach under Constraint Market Pricing (CMP). “The cost of developing the requisite evidence to present a case under the *Coal Guidelines* procedures could prove to be prohibitive relative to the potential relief a complainant might realize by prevailing on the merits of the case.” A Stand-Alone Cost analysis by shippers with “diverse origins and relatively low volume shipments,” like the Montana shippers, would “be extremely complex and would entail substantial expenditures, in terms of time and money, relative to the possible savings to be obtained through rate re-

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81. *Id.* at 551 (Strenio, Commr., concurring).
82. Consol. Rail Corp., 812 F.2d at 1457.
83. *Id.* at 1457–1458 (Becker, J., concurring).
84. *Id.* at 1462.
85. *Id.* at 1463.
86. *Id.* at 1465.
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For example, McCarty Farms itself was one of the larger grain producers in the shipper class, and its annual shipment of 3,000 tons amounted to less than one-third the tonnage in one trainload of coal. Thus the Commission decided that McCarty Farms would be the first rate proceeding in which it would apply a proposed alternative to CMP to determine maximum rate reasonableness.

The alternative method, the unimaginatively named Non-Coal Guidelines, relied on the relatively simpler R/VC comparison used in the statutory market dominance determination. Previously, the Commission declined to rely exclusively on “an arbitrary cost ratio” for rate reasonableness determinations. Simply comparing R/VC ratios between shippers (such as the Washington and Montana grain shippers in the example above) ignores the efficiency of differential prices under Ramsey pricing theory, and could result in the captive shipper eventually paying even higher rates if the railroad lost other shippers as it tried to recoup a greater share of fixed costs from more competitive parts of its network. To account for differential pricing, the Commission selected a benchmark comparison sample “with similar transportation and demand characteristics to the issue traffic,” which might serve as a control group paying reasonable rates at similar levels of demand inelasticity. The alternative method also relied upon only a benchmark sample of freight movements, a less complex and less costly analysis than the SAC method’s reliance on all movements over the route at issue.

For its comparison of benchmark wheat and barley rates in McCarty Farms, the Commission sampled presumably captive shipments of wheat and barley (those with the “jurisdictional” R/VC ratio of greater than 180%) moving more than 500 miles from major grain-producing areas of the United States, excluding Burlington Northern shipments from Montana. In an attempt to control for demand characteristics and efficiency-driven cost differences, the Commission segregated the sample into single-car, multiple-car (26-car segments), and trainload (52-car segments) shipments. Based on the average R/VC ratios within the sample group, the Commission tentatively determined that Montana wheat and barley shipping rates are unreasonable if they produced ratios above 2.14 for single

88. Id. at 840–841.
90. McCarty Farms II, 3 I.C.C.2d at 841.
91. Id. at 842.
92. Id. at 842 n. 29.
93. For a discussion of Ramsey pricing and differential prices, see supra Part II.B.1.a.
94. McCarty Farms II, 3 I.C.C.2d at 842.
95. Id. at 843.
96. Id.
97. Id. at 844.
cars, 2.33 for multiple cars, and 2.24 for trainloads. In an unpublished decision the Commission applied those ratios to the McCarty Farms shipments, calculating the overcharge based on the extent to which the average rates paid by the complainant shippers produced ratios that exceeded the average ratios produced by each benchmark sample group’s rates. Finding unreasonable rates only for trainload shipments from 1981 through 1986, the Commission awarded damages of more than $16 million, including interest. The shippers sought review of the decision in the District of Montana, but that court held that it lacked jurisdiction.

Both sides petitioned the District of Columbia Circuit for review of the ICC decision. That court rejected the shippers’ challenges to the Commission’s methods, while agreeing with the railroad on its single challenge: the Commission’s use of the R/VC ratio comparison in place of CMP was unreasonable and therefore invalid. The court cited several faults in the new method. First, setting a ceiling based on the benchmark sample’s average R/VC ratio would drive down the benchmark ratio each time a shipper subjected to an above-average ratio brought a challenge under the same method. In other words, every other shipper in the sample who paid rates producing an R/VC above the 2.24 ratio for trainloads could bring a challenge based on the new, lower average ratio that resulted from the rate reduction won by McCarty Farms (2.20, for example) and so forth, until the successive challenges reached the rate ceiling down at the jurisdictional floor of 180%. Even if such a sequence was unlikely, the court found a theory that allowed such results to lack “any glimmer of supporting principle or intellectual coherence.”

Second, the court found the Commission’s analysis flawed because it assumed sample rates for similarly sized grain movements (single car, multiple car, and trainload) were a useful proxy for different demand elasticities to satisfy Ramsey pricing principles. Rather than explaining why the sample movements could not reveal something about demand elasticity, however, the court simply deferred to the railroads’ pricing judgments because they had “the greatest interest in making” a correct judgment “that the issue traffic either costs more to transport or has a less elastic demand.”

The Commission’s method, according to the court, puts it “in the position

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98. McCarty Farms V, 985 F.2d at 601.
100. McCarty Farms IV, 787 F. Supp. at 947.
101. McCarty Farms V, 985 F.2d at 591.
102. Id. at 597.
103. Id.
104. Id.
105. Id.
of simply correcting (or purporting to correct) railroad management decisions as to what prices will most benefit the railroad.” 106 This explanation falls short, however, because the premise of the Commission’s jurisdiction is to “correct railroad management decisions”—and to make the rates reasonable—if those decisions abuse their monopoly power over captive shippers.107 Still, it is difficult to discern from the Commission’s reasoning why there should have been a significant correlation between the volume of a particular shipment (correlated with grain production at an origin) and the demand inelasticity of the shipper (correlated with carrier competition at an origin). One possibility may be that high-volume captive shippers are more likely to be demand-inelastic “price takers” because there are fewer substitutes for shipping large volumes by the trainload than there are for shipping smaller volumes by the carload. Ultimately, as the shippers’ economist conceded, the R/VC comparison method primarily measures “exploitation” or discrimination among similarly situated grain shipments, rather than demand elasticity among similarly situated grain shippers.108

Third, the court criticized the absence of any consideration of revenue adequacy in the R/VC comparisons.109 In particular, the court noted that Burlington Northern’s revenues were inadequate for each of the six years for which refunds were ordered, so “it is not entirely clear why the rates charged constituted an abuse of market power.”110 Again, however, the court made a leap of logic from criticizing the Commission’s method to assigning error in its result. As the Commission explained in Coal Guidelines, “a rate may be unreasonable even if the carrier is far short of revenue adequacy” because captive shippers should “not be required to shoulder an unreasonable share of carriers’ revenue need shortfalls.”111 A finding of unreasonable rates only impinges on the revenue adequacy interest “[i]f a carrier’s revenue inadequacy were severe, or if rate relief would have a severe effect on the attainment of revenue adequacy in the future.”112

Finally, the court questioned the need for alternatives to the SAC method under CMP. Taking the McCarty Farms class as a whole, it found comparable coal cases that applied the SAC method for similarly sized shipment volumes and similarly large numbers of origination points.113 The court concluded that “the Commission has by no means shown that the number of origin-destination pairs or the density of the traffic raise the in-

106. Id.
108. McCarty Farms V, 985 F.2d at 598.
109. Id.
110. Id. at 597–598.
111. Coal Rate Guidelines, Nationwide, 1 I.C.C.2d at 520.
113. McCarty Farms V, 985 F.2d at 598.
formation costs so drastically as to justify scuttling CMP.”114 Moreover, according to the court, the availability of aggregating claims by a state entity such as the Montana Department of Agriculture (a party to McCarty Farms) and cost-shifting made the small shippers’ concerns “seem[ ] quite weak.”115

C. The End of the I.C.C. and McCarty Farms

On remand, the Commission sought direction from the parties about whether it should proceed with a CMP analysis of the challenged rates,116 After the parties elected the SAC approach to CMP, but before the Commission could apply it, Congress passed the I.C.C. Termination Act to abolish the Commission and transfer pending rail-rate cases to the newly established Surface Transportation Board (Board).117

Under the SAC approach, the shippers presented the Board with a hypothetical “Farmers Railroad” that ran along Burlington Northern’s route from Chicago to Seattle.118 The parties fought over the smallest details, such as how many acres would require seeding and whether a hypothetical railroad tie for the Farmers Railroad should cost $37.80 or $56.14.119 Applying the SAC test originally developed in the Coal Guidelines, the Board concluded that the hypothetical Farmers Railroad “would not have generated sufficient revenues over the twenty-year analysis period [1979-1988] to cover all the costs that would have been incurred during that same period.”120 This time, the shippers lost.121

On petition for review, and after an unpublished modification of the Board’s order, the District of Columbia Circuit did not conduct an in-depth theoretical critique as it had in the prior appeal. Instead, it briefly held “the STB has rationally set forth the grounds on which it acted, and its findings are based on substantial evidence.”122 The court also rejected the shippers’ attempt to carve its single-car rate claims out of that court and into the U.S.

114. Id.
115. Id. at 599.
119. Id. at *26, *31.
120. Id. at *43.
121. See Salvatore Massa, Injecting Competition in the Railroad Industry Through Access, 27 Transp. L.J. 1, 22 (2000) (“The woeful state of shipper redress . . . is perhaps best illustrated by the litigation in McCarty Farms v. Burlington Northern Railroad Co. . . . . Prior to this final STB decision, the McCarty Farms case was used as a model of an effective example of market dominance and unreasonable rates.”), citing Wesley A. Wilson, Legislated Market Dominance in Railroads, in Research in Transportation Economics 49, 58–62 (B. Starr McMullen, ed., JAI Press 1994).
122. McCarty Farms VII, 158 F.3d at 1301.
District Court of Montana. After *McCarty Farms VII*, the shippers did not press further their remaining pre-1981 rate claims originally filed in the U.S. District Court of Montana. The dispute’s 18-year “crawl through the legal system” had ended.

III. THE SURFACE TRANSPORTATION BOARD IN THE AFTERMATH OF *MCCARTY FARMS*

Congress passed the Interstate Commerce Commission Termination Act (Termination Act) in 1995. Just before its termination, the Commission concluded that it could not find “a satisfactory means of simplifying the CMP analysis in a way that would adhere to the theory, and approximate the results, of CMP.” Still, Congress asked the newly constituted Surface Transportation Board to “establish a simplified and expedited method for determining the reasonableness of challenged rail rates in those cases in which a full stand-alone cost presentation is too costly, given the value of the case.” The Board worked on such procedures since seeking proposals for the *Non-Coal Guidelines* in 1986. After a decade of study, it concluded that “because precision must be sacrificed for simplicity, any simplified procedures will necessarily be very rough and imprecise,” and “must be used as sparingly as possible, reserved for only those cases where CMP is not a realistic option.”

A. Three Benchmarks

The Board’s first attempt to simplify rate reasonableness methods built upon the failed application of the R/VC ratio in *McCarty Farms* to develop a “Three Benchmark” test. The original R/VC ratio comparison was refined into a measure, called R/VC[COMP], which added an important screen to the sample group: the comparison shipments must not be “readily susceptible to transportation by another available mode, at least at the distances involved in the complaint.” Once the sample group is limited to rail-dependent traffic, and assuming that due to the consolidation of transcontinental railroads the shipper “usually does not have a choice between two rail carriers for the entire move,” the refined test can “presume that properly selected comparison traffic will have a similar degree of demand.

123. *Id.* at 1299.
124. *Id.* at 1296.
127. *Id.* at 1010.
128. *Id.* at 1021.
129. *Id.* at 1035 n. 90.
elasticity.” 130 As the Board pointed out, railroads too must rely on indirect means of measuring demand elasticity in setting demand-based differential pricing, and an “imperfect approach is far preferable to abandoning any effort to take demand-based differential pricing into account in a simplified analysis.” 131 A second criticism of R/VC[COMP] was the “ratcheting” effect of successive applications of an average rate ceiling; the Board sought to mitigate that effect by excluding previously prescribed average rates from the sample group. 132

Another criticism of R/VC[COMP] in McCarty Farms was its failure to take into account the revenue adequacy mandate. 133 The Board incorporated revenue adequacy into its second benchmark, the Revenue Shortfall Adequacy Method (RSAM). It measures the “the uniform markup above variable cost that would be needed from every shipper of potentially captive traffic (the [R/VC]>180 traffic group) in order for the carrier to recover all of its . . . fixed costs,” and therefore attain revenue adequacy. 134 In a rough approximation of Ramsey pricing principles, RSAM theoretically groups all potentially demand-inelastic shippers into a single “potentially captive” group sharing the fixed costs unrecovered from the other potentially demand-elastic shippers—those with R/VC ratios under 180%. The railroad’s annual revenue shortfall represents the unrecovered costs. In theory, the RSAM benchmark is a revenue adequacy ceiling measured in R/VC terms that performs a function similar to the Revenue Adequacy Constraint of CMP.

The third benchmark, R/VC[>180], measures the average markup charged by the railroad to potentially captive traffic, or, in R/VC terms, the average R/VC ratio for all traffic producing R/VC ratios over the “potentially captive” level of 180%. 135 Whereas R/VC[COMP] attempts to measure comparable captive shipper rates across railroads to place the shipper in context among other shippers, R/VC[>180] attempts to measure the railroad’s reliance on captive shipper rates to place the shipper in context within the railroad’s traffic. This benchmark considers the relative fairness of the railroad’s rate structure, “to ensure that the complaining shipper’s traffic is not bearing a disproportionate share of the carrier’s revenue requirements vis-à-vis other relatively demand-inelastic traffic without good cause.” 136

130. Id.
131. Id. at 1034.
132. Non-Coal Proceedings, 1 S.T.B. at 1037.
133. McCarty Farms V, 985 F.2d at 598.
134. Non-Coal Proceedings, 1 S.T.B. at 1027.
135. Id. at 1038.
136. Id.
The Board expected that the Three Benchmark method would consider the relevant statutory factors of reasonableness and revenue adequacy, with each benchmark serving as a check on the other two, while the Board would remain open in a rate case to any other “particularized evidence” bearing upon the proper application of the benchmarks.\textsuperscript{137} The Board emphasized its simplified method was motivated by a “modest objective—to make at least a rough call as to rate reasonableness in those cases where a more precise determination is not possible.”\textsuperscript{138}

Despite the Board’s modest expectations, the Three Benchmarks gathered dust. Railroads challenged the standards as “vague and unilluminating,” but the D.C. Circuit found the challenge “unfit for review” at least until “the Board applies the guidelines in a concrete case.”\textsuperscript{139} A decade after their adoption, no shipper had pursued a case to decision under the Three Benchmarks.\textsuperscript{140} Based upon comments the Board received, the shippers had finally found common ground with the railroads: they perceived “the existing guidelines as too vague, and as requiring prolonged litigation over whether a shipper even qualifies to use them.”\textsuperscript{141} The Board returned to the drawing board in the \textit{Simplified Standards} proceeding. There, the Board recalibrated some of the Three Benchmark formulas and implemented two new initiatives: a Simplified Stand-Alone Cost method and streamlined procedures for small shipper rate cases.\textsuperscript{142}

\textbf{B. \textit{Simplified Stand-Alone Cost}}

The Board observed that “CMP, with its SAC constraint, is the most accurate procedure available for determining the reasonableness of rail rates where there is an absence of effective competition.”\textsuperscript{143} Yet the last attempt to simplify the SAC method was the railroad’s model that produced “reasonable rates” at R/VC ratios of 5,000\%, meaning a railroad could charge shippers fifty times its variable costs.\textsuperscript{144} In the new proceedings, the railroads again preferred Simplified-SAC to the Three Benchmark method, while the shippers asked the Board to abandon or delay implementation of Simplified-SAC.\textsuperscript{145} The Board concluded that both approaches “should be made available to shippers.”\textsuperscript{146}

\begin{thebibliography}{10}
\item \textsuperscript{137} Id. at 1041.
\item \textsuperscript{138} Id.
\item \textsuperscript{139} Assn. of Am. R.Rs. v. Surface Transp. Bd., 146 F.3d 942, 945, 948 (D.C. Cir. 1998).
\item \textsuperscript{140} \textit{Simplified Stands. for Rail Rate Cases}, 2007 WL 2493509 at *2 (Surface Transp. Bd. 2007).
\item \textsuperscript{141} Id.
\item \textsuperscript{142} Id. at *4.
\item \textsuperscript{143} Id. at *10.
\item \textsuperscript{144} \textit{Non-Coal Proceedings}, 1 S.T.B. at 1012.
\item \textsuperscript{145} \textit{Simplified Stands. for Rate Cases}, 2007 WL 2493509 at *3.
\item \textsuperscript{146} Id.
\end{thebibliography}
The key to simplifying SAC was to replace the exhaustive “assume-a-railroad” requirement with a less-demanding assumption that “all existing infrastructure along the predominant route used to haul the complaint traffic is needed to serve the traffic moving over that route.”\footnote{Id. at *11.} In other words, Simplified-SAC takes the railroad as it is, assumes that the existing configuration is efficient, and focuses exclusively on the railroad’s rate structure to determine “whether the captive shipper is being forced to cross-subsidize other parts of the railroad’s rail network.”\footnote{Id.} Underlying this efficiency assumption is the Board’s belief that “[r]ailroads no longer are burdened by substantial excess capacity,” and instead their facilities are strained by increasing demand.\footnote{Id.} In any event, whether that belief is true for the purposes of a Simplified-SAC case matters less than whether it is expedient; “even if the management of some railroads is not as efficient as possible, the burden of uncovering and quantifying existing inefficiencies is so substantial as to be impracticable in all but the largest rail rate disputes.”\footnote{Id.}

C. Simplified Procedures and Eligibility Criteria

Before a shipper could know whether it qualified for relief, the Commission’s and the Board’s former rules required a complainant to pay prohibitive filing fees and litigation expenses.\footnote{For a legal critique of the filing fees, see generally P. Pfohl, Who Should Pay for Agency Adjudication? A Study of $200,000 Filing Fees at the Surface Transportation Board, 26 Trans. L.J. 57 (1997).} At the time of Simplified Standards in 2007, the filing fee for a SAC case was $178,200\footnote{Simplified Stands. for Rate Cases, 2007 WL 2493509 at *57.} and a shipper’s litigation costs could amount to $5 million in legal and consulting fees to build and advocate for a theoretical stand-alone railroad.\footnote{Id. at *23.} Even under the new standards, the Board estimated that a Simplified SAC case would cost $1 million\footnote{Id.} on top of the filing fee of $10,600.\footnote{Id. at *57.} The Three-Benchmark filing fee has remained a more accessible $150,\footnote{Id. at *24.} and the Board has estimated the litigation cost at $250,000.\footnote{Id. at *24.} Still unsatisfied with the cost of filing a case with the Board, Congress limited all rate-complaint filing fees to $350.\footnote{Consolidated Appropriations Act, H.R. 2764, 110th Cong. (Jan. 4, 2007); cf. 49 C.F.R. § 1002.2(f)(56) (2008).}
Given the imprecision of the simplified standards, and without the financial barriers of a full SAC case and filing fees to limit shipper challenges, the railroads suggested that the simplified procedures be subject to relief limits. The Board agreed and developed eligibility levels based on the cost to litigate the next most costly case; thus a shipper seeking relief of less than the $1 million cost of a Simplified-SAC case would be eligible for a Three Benchmark case, and a shipper seeking relief of less than the $5 million cost of a full SAC case would be eligible for a Simplified-SAC case. Recoveries under either simplified standard would be limited to five years. Shippers objected to the limits. A claim of $2 million, for example, could only succeed in a Simplified-SAC case, which, at the cost of $1 million to litigate, would reduce the expected recovery by half. The Board responded that the “risk factor” associated with the expected recovery should be limited to four or five times the cost of litigation. Beyond this, the Board expressed a concern that shippers might disaggregate large claims into several smaller claims to exploit the perceived cost advantages of bringing a case under the simplified standards.

Reviewing the reforms under the simplified standards, the Board attempted to quantify how wide it opened the door to captive shippers previously shut out by the expense of a full SAC case. Based on a rate sample for captive shippers, and assuming a maximum recovery over five years of all charges over the jurisdictional floor R/VC ratio of 180%, the Board concluded that shippers representing 73% of potentially captive traffic had been denied the opportunity to seek relief under the prohibitive costs of a full SAC case, and 45% of that traffic also would have found the Simplified-SAC too costly. Farm-product shippers faced an even higher hurdle: a full SAC case was impracticable for 89% of the traffic, and the untested Three Benchmark method was the only practical source of relief for 60% of the traffic. Between 1990 and 1998, only 2 out of 41 shipper complaints under consideration resulted in an award of damages for the shipper, and both were coal shippers; 18 more resulted in settlements. Between 2001 and 2006, only ten cases have been filed, nine of them by coal shippers.

After these dismal reflections on the past, the Board has expressed cautious optimism that the simplified standards are “an important step for-

160. Id. at *25.
161. Id. at *21.
162. Id.
163. Id. at *27.
164. Id.
165. Issues Associated with the Rate Relief Process, supra n. 79, at 6–7.
ward in creating a workable structure for resolving rate disputes of all sizes.” 167 Commissioner Buttrey expressed a more particular aspiration. “In 1887, the genesis of U.S. railroad regulation arose from concerns about rates for grain shippers.” 168 Now, with the Board’s renewed attempt to fulfill its mandate for the nine out of ten farm shipments that were shut out for the past three decades, he hoped that the reforms could give grain shippers “a more reasonable opportunity to prevail in a small rate case if their rates are unusually high.” 169 Meanwhile, several railroads have petitioned for review of the new standards. 170

IV. THE LEGACY OF MCCARTY FARMS

Congress’s legislative response to the railroad crisis of the late 1970s, followed by three decades of oversight by the Commission and the Board, has succeeded in giving the railroad industry its comeback. Since 1980, the number of freight ton-miles carried by railroads has nearly doubled, and the railroads’ share of inter-city freight has rebounded from a low of 26% in 1985 to 38% in 2005. 171 Over this period, railroads have consolidated their operations and facilities, as the number of Class I railroads has declined from 40 to 7. 172 In the past two decades, railroads have reduced their miles of track owned by nearly 27%. 173

In the last decade, the railroad industry’s financial performance measured by earnings-per-share growth has met or exceeded the growth of the S&P 500 Index. 174 Railroads’ return on investment has stabilized over the past decade, indicating “an increasingly strong freight railroad industry.” 175 The Board recently concluded that “even after factoring out rising fuel costs, railroad rates have risen in the past three years after falling for decades.” 176 Burlington Northern’s successor, Burlington Northern Santa Fe (BNSF), more than doubled its dividend between 1997 and 2007, and its

168. Id. at *31.
169. Id.
170. Simplified Stands. for Rail Rate Cases, 2007 WL 2816248.
174. Id. at ES–27.
175. Freight Railroads, supra n. 1, at 9–10.
Captive Regulators, Captive Shippers

2009

CAPTIVE REGULATORS, CAPTIVE SHIPPERS

BNSF’s earnings per share increased 19% in 2008. Its average agricultural product revenues per car/unit increased by 23% on a ton-mile increase of just 5.2% over 2008; and in the fourth quarter, as agricultural product ton-miles dropped 10.9%, its average car/unit revenues actually increased 20% due to what the railroad termed “strong yields” in its pricing. These results came during the American economy’s worst quarterly performance in a quarter century.

The railroads’ revival, however, comes at the expense of the grain shippers whose money supports those “strong yields.” Unlike other commodity freight rates, grain rates increased by 9% between 1985 and 2004. Railroad consolidation has not passed on the efficiencies to captive grain farmers; for similar long-distance grain routes to Portland, Oregon, the rates from North Dakota, with one Class I railroad, are approximately double the amount from South Dakota with two Class I railroads. While the overall ratio of rail shipper captivity to railroad monopolies has declined between 1994 and 2004, shipper captivity in Montana and similarly situated states has increased by 25% or more. Similarly, while the number of “potentially captive” shipments with R/VC percentages over 180% has decreased since 1985, the number of high-markup shipments with R/VC percentages over 300% has increased. Over the past decade, the share of grain shipments from the Billings area to the Portland area traveling at over 300% R/VC have increased from almost zero to about 50%. The Lerner Index, which measures a railroad’s monopoly power as a “markup” ratio above marginal cost, is higher for grain shipments than any other commodity and is rising. This indicates that “grain shippers are not unjustified in viewing themselves as paying relatively high markups.”

A 2009 study confirms the impact of railroad captivity on Montana grain shippers, the successors to the McCarty Farms class. Rail freight

179. Id. at 11, 2.
182. Id. at 21.
183. Id. at 27–28, 34 fig. 18.
184. Id. at 31–32; see also Laurits R. Christensen Assocs., Inc., supra n. 171, at ES–11 (ton-miles over 300 percent R/VC increased from 5 percent to 9 percent from 2000–2001 and 2005–2006).
185. Freight Railroads, supra n. 1, at 35 fig. 19.
rates for wheat shipments are higher per-car and per-ton in Montana than in any other major grain-shipping state, despite comparable shipping distances from Kansas, Nebraska, North Dakota, and South Dakota. For 2006, the study reported R/VC ratios for Montana wheat shipments to the Pacific Northwest of 288% for shuttle trains of more than 100 cars—the predominant mode of grain transportation from Montana—compared to an average of 240% for shuttle trains in the peer states; non-shuttle trains showed R/VC ratios of 248% and 216% for Montana and the peer states, respectively. Based on these rates, Montana grain shippers would have paid $19 million less annually to BNSF if they enjoyed their peer state R/VC ratios, and approximately $50 million less if they paid at the R/VC jurisdictional level of 180%.

Meanwhile, BNSF’s emphasis on shuttle-train service led to a reduction of grain elevators in Montana from almost 200 in 1984 to less than 50 today, despite increased production. Seventy percent of Montana grain producers are hauling grain farther to the grain elevator, while the average haul for those producers has extended to more than 20 miles, both of which shift costs from the railroads and grain elevators to the producers. The study concluded that its results “make a compelling case for rate relief,” but with the reduction in grain elevator ownership since McCarty Farms, the direct shippers with the strongest case for relief are “reluctant to jeopardize” their relationships with the sole market-dominant railroad, BNSF.

A. Congress’s Next Acts in Regulatory Reform

In the late 1970s, railroads wondered whether clear actions, in what became the Staggers Act, would follow Congress’s bold statement in the 4R Act. Captive shippers do not face the existential threat that was posed to some railroads three decades ago, but they do find themselves in a similar situation. The Termination Act prodded the new Board to make rate challenges work for the vast majority of captive shippers for whom “assume a railroad” was not an option. More than a decade later, captive shippers are still waiting for clear actions that will make rate relief a reality. Two bills under consideration by Congress propose such clear actions. While both bills contain steps in the right direction, their successful implementation...
depends on understanding the institutional lessons of *McCarty Farms*. Those lessons identify limits on the regulatory model that the Board, the railroads, and captive shippers have inherited, and suggest how the model’s goals may be realized under reformed laws.

The first proposal reemphasizes the pro-competition and rate-regulation mission of the Board, clears away Commission and Board decisions and policies that did not fulfill that mission in the past, and makes one more attempt to simplify rate guidelines. The second proposal would give the Board itself competition on the enforcement side by subjecting railroads to the same antitrust review and liability imposed on other industries, regulated and unregulated alike. Together, they offer contrasting yet potentially complimentary institutional approaches to the captive shipper problem, one relying on the Board’s expertise to enforce more detailed statutory prescriptions, and the other relying on the courts’ independence to enforce the broader competition norms of antitrust law.

1. *The Railroad Competition and Service Improvement Act*

The 111th Congress likely will consider a broad reform of the Board’s powers and mission, similar to a bill introduced in the previous Congress: The Railroad Competition and Service Improvement Act of 2007 (Competition Act).[^194] If reintroduced and enacted, the Competition Act would reorient the STB toward “implementation directives” of “effective competition among rail carriers” and “reasonable rates for rail customers in the absence of competition,” without the railroad support mechanisms that characterized and even compromised the regulatory goals of the 4R and Staggers Acts.[^195]

Several of the Act’s provisions would clarify the legality of certain railroad practices and overturned the Board’s decisions to the contrary. Railroads would have to quote “bottleneck rates” for service to any two points on the railroad’s line, including on “bottlenecks” where one railroad controls a segment within a rail route that is otherwise competitive; a shipper could then pay (or challenge) uncompetitive rates only on the bottleneck segment, and potentially benefit from competitive rates on the remainder of the route.[^196] “Paper barrier[s],” agreements by short-line or regional railroads not to interchange traffic that would compete with a dominant national railroad (from which they may have purchased or leased track),

[^195]: Id. at § 101.
[^196]: Id. at § 102; see also *Freight Railroads*, supra n. 1, at 48–49 & fig. 24 (Bottleneck rates “would require a railroad to establish a rate, and thereby offer to provide service, for any two points on the railroad’s system where traffic originates, terminates, or can be interchanged.”); *MidAmerican Energy Co. v. Surface Transp. Bd.*, 169 F.3d 1099, 1107 (8th Cir. 1999) (deferring to Board’s determination that a railroad’s common carrier duties did not require it to quote separate bottleneck rates).
would be presumptively illegal. The Board could mandate “reciprocal switching” to allow railroads access to nearby shippers and to set the terms if the railroads could not agree. A governor could petition the Board for designation of a state as an “area of inadequate rail competition,” applicable to highly captive states like Montana. That designation would provide the Board near-plenary authority to remedy “inadequate rail competition” within its jurisdiction.

The Competition Act also would provide captive shippers “a right of access,” which is not defined further, to rate-reasonableness determinations. More specifically, the Act would require the adoption of “a method for determining the reasonableness of rail rates based on the railroad’s actual costs,” which could not be “based on the costs of a hypothetical competitor.” It also would provide for final-offer arbitration, which Canada has used to resolve disputes between railroads and shippers. That provision reiterates the Act’s opposition to Stand-Alone Cost methods, barring the use of “any method based on stand-alone cost, the costs of a hypothetical competitor, or . . . precedent adopting or applying such methods.” The Act would empower the Board to initiate investigations on its own and to enjoin preliminarily railroad activities having effects beyond a single complainant.

2. The Proposed Railroad Antitrust Enforcement Act

Congress also has introduced a bill that would enable antitrust enforcement against railroad activities under the Board’s jurisdiction that tradition-

197. Sen. 953, 110th Cong. at § 103; see also Freight Railroads, supra n. 1, at 50–51 & fig. 25; Review of Rail Access & Competition Issues—Renewed Pet. of the W. Coal Traffic League, 2007 WL 3170981 (Surface Transp. Bd. 2007) (reviewing paper barrier “interchange agreements . . . including credits for cars interchanged with the seller or lessor carrier, a penalty for traffic interchanged with another railroad, or a total ban on interchange with any carrier other than the seller or lessor carrier,” requiring certain disclosures of such agreements but declining to find such agreements unreasonable in themselves). Notably, Montana Rail Link, the regional railroad that interchanges with BNSF within Montana, has complained of its dependence on a dominant railroad, insisting “that the combination of paper barriers and marketing agreements [that give a dominant railroad the exclusive right to market and price interline traffic] very often puts the fate of small railroads and their shippers squarely in the hands of the small railroad’s Class I connection.” Major Rail Consolidation Procedures, 2000 WL 1535932 (Surface Transp. Bd. 2000).

198. Sen. 953, 110th Cong. at § 104; see also Freight Railroads, supra n. 1, at 44–45 (reciprocal switching “would allow STB to require railroads serving shippers that are close to another railroad to transport cars of a competing railroad for a fee . . . . STB would oversee the pricing of switching agreements.”).

199. Sen. 953, 110th Cong. at § 105.

200. Id.

201. Id. at § 301.

202. Id. at § 302.

203. Id. at § 304; Montana Shippers, supra n. 187, at 25.

204. Sen. 953, 110th Cong. at § 304.

205. Id. at § 401.
ally were immune from liability under statute or judicial doctrine: The Railroad Antitrust Enforcement Act of 2009 (Antitrust Act). It would restore the relationship between rail-rate regulation and antitrust liability as it existed in the early days of both laws, when the United States Supreme Court held that the Sherman Act “covers, and was intended to cover, common carriers by railroad,” notwithstanding the Interstate Commerce Act.

The Act would extend antitrust review under Section 7 of the Clayton Act to railroad mergers, rather than vesting exclusive merger-review power in the Board. Previously, the STB exercised its exclusive jurisdiction to approve the 1996 merger of the Union Pacific and Southern Pacific Railroads under a general “public interest” standard, a decision the law required a reviewing court to give “considerable deference.” The Justice Department recommended that the Board deny the merger, arguing that it would give Union Pacific a monopoly in hundreds of western markets and possibly would result in $800 million in consumer price increases annually.

The Act also would overturn judicially-created immunity based on the filed-rate doctrine as it applies to rates within the Board’s jurisdiction. Federal and state antitrust enforcement agencies, as well as private parties, could pursue treble-damage antitrust claims against railroads “without regard to whether such railroads have filed rates or whether a complaint challenging a rate has been filed.” That provision, and another provision opening the railroads to private actions for injunctive relief, may open to challenge some of the practices that also would be prohibited by the Competition Act. “Primary jurisdiction,” the doctrine that first brought the McCarty Farms case to the Commission for an original determination of rate reasonableness, would not be required for antitrust claims. The Act would terminate several other antitrust exemptions for Board-approved agreements among railroads.

B. Procedural Lessons from Institutional Failure

In its most recent Simplified Standards proceedings, the Board was at a loss to explain the blank docket of small shipper complaints since its first

208. Sen. 146, 111th Cong. at § 3.
211. See Keogh v. Chi. & N.W. Ry., 260 U.S. 156, 163 (1922) (“The legal rights of shipper as against carrier in respect to a rate are measured by the published tariff. Unless and until suspended or set aside, this rate is made, for all purposes, the legal rate, as between carrier and shipper.”).
212. Sen. 146, 111th Cong. at § 6.
213. Id. at § 2.
214. Id. at § 4.
215. Id. at § 7.
reconfiguration of the simplified guidelines in 1996. Since *McCarty Farms* and the Staggers Act both got their start in 1980, the Commission and the Board have constantly reworked the rules and guidelines in cases and ex parte proceedings, attracting a steady flood of commentary, challenges, and petitions for review before the federal courts. The rate reasonableness guidelines are only the front lines of a 30-year war between railroads and shippers; they also keep fighting smaller but strategically important battles over revenue adequacy, costs, and market dominance, all the while keeping a close eye on potentially outflanking maneuvers in Congress.

The *McCarty Farms* and *Simplified Standards* stories leave the impression that these proceedings form the battleground where reasonable rates and revenue adequacy will be won or lost. Perhaps, advocates could think, resolution is as close as a court decision sustaining the Three Benchmark Method or the Competition Act’s slaying of Stand-Alone Cost. Yet it is worth stepping back to consider the institutions and incentives that constitute the order of battle and the rules of engagement in the railroad rate fights. Not even the purest economic theory can properly allocate the costs and benefits of captive rail shipping without a workable process to translate theory into reality. The Commission and the Board have lacked that process for several institutional reasons that one can isolate from the broader policy and economic debates in railroad regulation.

1. **The Staggers Act Formalized Regulatory Ambivalence**

At the time of the classic work on “regulatory capture” in 1971, it was already observed that “[s]o many economists . . . have denounced the ICC for its pro-railroad policies that this has become a cliché of the literature.” It is not, therefore, a novel finding that the Board’s decisions continued to have the effect of favoring a few concentrated railroad interests over many diffuse shipping interests.

What is novel about the post-Staggers Act regime is that the Commission and Board assumed a duty to protect railroad interests and that this duty of ensuring revenue adequacy expressly constrains the original rate-regulation duty of the Commission. Formally, the Board, and the Commission before it, has possessed an ambivalent mission to protect both railroads and shippers. Notwithstanding the intervening ICC Termination Act, the Board works within a regulatory model built to save the American railroad industry. Mission accomplished.217

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217. See id. at Part IV.
As the industry often points out, the Board’s future decisions are not free of risk for railroads. Yet there are risks on the other side, too, and history since the Staggers Act suggests that the financial risks to captive shippers of the Board’s inaction have been great, even if they have not been visibly catastrophic. The costs of regulatory inefficacy to farms and other small captive shippers are diffuse, indirect, and difficult to ascribe to the Board, while a railroad’s failure would appear to be a clear failure of the Board. These regulatory optics have distorted the Board’s construction of its statutory mandate beyond the effects of regulatory capture by railroad interests. So the Board tends to err on the side of revenue adequacy for railroads, even at great costs to captive shippers, because a major railroad bankruptcy would prove a far more salient failure of the Board than the millions of potentially unrecognized overcharges.

The Board’s aversion to the risk of railroad failure, and the aversion of the Commission before it, may reflect the traumatic birth of its regulatory model in the railroad crisis of the 1970s. Thirty years later, however, that historic aversion persists despite the railroads’ success under the Staggers Act and, in the absence of an offsetting aversion towards unreasonable rates, imposes a cost on captive shippers. Revenue adequacy is a command, but it is no more a command than rate reasonableness. Given that the two commands conflict, risks will always present themselves in any course of action. The Competition Act’s new shipper-oriented “implementation directives” would give the Board a reason to reassess implicitly the balance of risks but would fail to tip the scales decisively in favor of the shipping public. As an early observer of the Interstate Commerce Commission’s capture by the railroads explained, “[w]hen such a commission loses its objectivity and impartiality by becoming dependent upon the support of a single narrow interest group, . . . it becomes necessary to subordinate this agency to some other agency possessing a broader outlook and a broader basis of political support.”

The simpler pro-consumer orientation of federal, state, and private antitrust enforcers bringing claims to independent generalist judges may prove a surer escape from regulatory captivity.

218. Woodman & Starke, The Competitive Access Debate: A ‘Backdoor’ Approach to Rate Regulation, 16 Transp. L.J. 263, 281 (1988) (arguing that structural “competitive access” remedies would result “in rate increases, lost traffic, decline in revenues, lost jobs, and deterioration in service—the same litany of woes, it should be noted, that characterized the rail industry in the days of significant Government regulation”).

219. See B. Bump, Held Captive: How Increased Regulation Arrests Railroads’ Ability to Serve the Nation, 5 DePaul Bus. L.J. 731, 752–756 (2007) (arguing that the Board can best serve the public interest by favoring the “long-term” protection of railroads over the “short-term” protection of shippers).

220. Huntington, supra n. 9, at 508.


The Commission’s and Board’s institutional tendency toward regulatory capture is exacerbated not only by an ambivalent mission to protect railroads alongside shippers, but also by the complexity of the regulatory structure put in place to execute that mission. Regulatory simplicity can limit this tendency by promoting a more focused and transparent agency mission; “[d]iscretionary regulation is hard enough; baroque elaboration of regulatory principles may confound an already intractable task.”

Strong, clear regulations “minimize the opportunity for mischief” where otherwise “overloaded regulators [may] reflexively protect the firms and legal structures they know best.” As the D.C. Circuit recently recognized, there is “an institutional interest in reducing the cost for parties litigating rate cases,” and the Board has broad discretion to serve that interest by streamlining its procedures and increasing the predictability of its jurisdiction.

Further efforts toward an accessible rate relief process are limited, however, by an economically arbitrary jurisdictional rule and a procedurally complex standard for rate relief.

The only fixed point in the constantly shifting regulatory landscape under the Staggers Act has been the 180% R/VC ratio that serves as the statutory threshold for what the Board has designated “potentially captive” shipping rates. But this number conveys a false precision. The complex methods of accounting for railroad rates and revenues are subject to dispute and manipulation. Beyond this, drawing a bright line at the 180% level lacks an economic justification.

A Congressional compromise on the number in the Staggers Act made a rule where there should be a standard. Changes in railroad costs, revenues, and markets year to year, and over thirty years, call for a more flexible standard of captivity and rate-relief

223. Id. at 1658.
224. BNSF Ry., 526 F.3d at 776.
225. See e.g., Rail Fuel Surcharges, 2007 WL 201205 at *8 (Surface Transp. Bd. 2007) (requiring reporting of fuel surcharges to increase rate transparency); Major Issues in Rate Cases, 2006 WL 3087168 at *12 (Surface Transp. Bd. 2006) (expressing concern that rate relief rule “permits the railroads to unfairly manipulate the outcome” of rate cases).
226. One post-Staggers Act study of western coal shipping found that railroads exercised limited monopoly power (capturing about 25% of monopoly rents) at a mean R/VC ratio equivalent of 133%, but concluded that further study into the determinants of shipper captivity was required. P. V. Garrod & W. Miklius, ‘Captive Shippers’ and the Success of Railroads in Capturing Monopoly Rent, 30 J.L. & Econ. 423, 439–440 (1987).
based on the economics of the industry as it exists today. For years, the Board has carefully calibrated its fee schedule yearly to its own labor costs, as required by statute, but Congress has not recalibrated the most critical metric in the Board’s jurisdiction since before the end of the Milwaukee Road. In practice, the 180% threshold also suffers from the same risk aversion imbalance exhibited in the revenue adequacy assessments; the Board’s rate guidelines suggest a greater concern with falling below the “jurisdictional” threshold for its captivity mandate than with the mandated provision of reasonable rate relief for every eligible captive shipper.

Conversely, where the Board could use a rule to help captive shippers assess their rate claims, it has imposed a standard. In McCarty Farms, the Commission temporarily solved a significant small shipper relief problem by applying an R/VC ratio comparison rule and running the numbers. Unfortunately, the comparison rule was insufficiently theorized, and the $16 million awarded was deceptively large, so the reviewing court held the Commission had “not intelligibly explained” its trade-off “between the quality and cost of possible regulatory approaches.” The days of rule-based relief ended and small shippers lost the guarantee of a certain measure of damages if rates were found to be unreasonably high. The Board replaced the idea of a clear rule for small shippers with a balancing test of three rules that amounted to a standard. As the Board learned while the standard gathered dust for ten years, lowering the costs of litigation does not invite more cases if a shipper cannot calculate the value of the relief afforded through litigation. Here, the Competition Act presents an opportunity for the Board to consider more predictable rate-relief formulas for small-shipper cases. A clearer policy directive from Congress could allow the Board to revisit the successful case-by-case benchmarking method applied by the Commission to grant the short-lived shipper relief in McCarty Farms.

3. Incentives Matter for Shippers and Railroads

The Competition Act would provide a “right to access” for shippers, but that means little without an improved understanding of the incentives shippers and railroads face in rate cases. The Board estimated that its least costly option for rate litigation, the Three Benchmark method, costs $250,000 based on a small-claims court model. It would take a very large “small claim” for a shipper to bring such a case. For example, McCarty Farms was one of the larger producers in its case, and it shipped 3,000 tons of grain annually. Assume that McCarty Farms paid current per-ton rates for shipping—approximately $33 according to the Montana Shippers re-
port\textsuperscript{230}—which amount to $100,000 in shipping costs per year. Assume the high end of the overcharge calculated in the *Montana Shippers* report: approximately 20%.\textsuperscript{231} With a $20,000 overcharge each year for five years, McCarty Farms could collect at most $100,000 from the Three Benchmark method. Even when recovery is assured at the high end of what an individual producer might claim, small shippers will not bring a case for $250,000 in litigation costs.

A reasonable level of risk also would deter medium and large shippers from bringing cases.\textsuperscript{232} A shipper with a fifty-fifty chance of success in pursuing a $2 million claim that costs $1 million to litigate under the Simplified-SAC approach would have no expected return,\textsuperscript{233} and the same analysis would apply to a large shipper with a fifty-fifty chance of success in pursuing a $10 million claim under the full-SAC approach with $5 million in litigation costs.

Now consider the railroad’s incentives. In Montana, BNSF earns $200 million in grain shipping revenues annually.\textsuperscript{234} Its 20% overcharge is $40 million, assuming all shipments in Montana are captive. If BNSF calculated a 50% chance of a successful challenge, its expected return on the illegal overcharge would be a loss of $5 million, and just a 60% chance of defeating a rate challenge results in a positive return for the railroad.\textsuperscript{235} This scenario may too optimistically assume a single challenge on behalf of all shippers in the state, with each shipper sharing a relatively small share of the litigation cost. Even if that were possible, who brings that case? After *McCarty Farms*, grain elevators consolidated: they have much to lose from challenging the one railroad on which their business depends, and comparatively little to fear from grain producers onto whom they can pass the railroad overcharge. After consolidation, grain elevators have increased their market power over the producers, who may rather pay a freight overcharge than drive another fifty miles to a competing elevator and back. Without any realistic prospect of multiple, large, successful rate challenges, the railroad will not be deterred from exploiting captive shippers. In other words, the Board’s protection of small captive shippers under the current rules is destined to fail.

\textsuperscript{230} *Montana Shippers*, supra n. 187, at 7.

\textsuperscript{231} Id. at 31.


\textsuperscript{233} Half of a $1 million gain after litigation costs plus half of a $1 million loss of litigation costs nets to zero.

\textsuperscript{234} *Montana Shippers*, supra n. 187, at 7.

\textsuperscript{235} Half of a $35 million gain after litigation costs ($17.5 million) plus half of a $45 million loss after litigation costs ($22.5 million) equals negative $5 million; 60% of a $35 million ($21 million) gain plus 40% of a $45 loss ($18 million) equals positive $3 million. In this scenario, the “break-even” probability of a successful challenge necessary to deter a rational railroad is 43.75%.
Both Congressional proposals discussed above offer solutions to the incentives problem. The Competition Act would allow the Board to initiate its own investigation under a provision for plenary relief proceedings in “areas of inadequate rate competition,” like Montana. The Antitrust Act opens enforcement to federal and state antitrust enforcers, including state attorneys general on behalf of shippers as parens patriae, and private parties. Antitrust actions would have the benefit of federal and state class action rules to aggregate claims that are unprofitable to bring individually. The Board should consider similar reforms, both to grant parens patriae standing to state attorneys general and to allow some form of class action.

4. Structural Remedies Should Complement Conduct Remedies

The ICC’s regulation of “all charges” was, in antitrust terms, a kind of conduct remedy as opposed to a structural remedy.236 Railroads had to do business under the constant control of federal regulators, at great cost to the railroads and, eventually, to the shipping public. The Staggers Act scaled back the ongoing conduct remedy to a limited class of captive shippers. The McCarty Farms story shows, however, that policing rate conduct for the benefit of a small class of consumers under the captive shipper criterion can prove as challenging for regulators as rate-setting for the entire industry under the original Interstate Commerce Act. This is especially true when the networked nature of the industry requires differential pricing, and the class of consumers entitled to “reasonable rates” is not always obvious or effective at asserting its entitlement. The ongoing need for regulating conduct in a dynamic industry also drives an endless cycle of litigating the standards for regulation.237

Structural remedies, such as blocking mergers or requiring asset divestitures, usually require a one-time intensive intervention, after which the market is left to function subject to the structure imposed by the intervention. Despite the continued challenges of administering a conduct remedy, however, the Commission and the Board have refused to impose structural remedies when likely anticompetitive mergers present themselves. The Board also has rejected more modest, if more administratively complex, remedies like “bottleneck rates.” The Competition Act would mandate


237. See e.g. Anne Binghaman, U.S Dept. Just. Antitrust Div., Statement on the Surface Transportation Board’s approval of the Union Pacific and Southern Pacific Merger, http://www.usdoj.gov/atr/public/press_releases/1996/228323.htm (last accessed Apr. 2, 2009) (“As a condition of approval, the Surface Transportation Board has given itself a significant regulatory oversight role for years to come in an effort to prevent this merger from being anticompetitive. We continue to believe that a competitive market structure—and not more regulation—is the best way to keep prices low in the railroad industry, as in every industry.”).
some of these “open access” remedies similar to the Telecommunications Act of 1996. The Antitrust Act could subject the railroads to similar structural remedies by repealing the applicable exemptions. It also would open the door to merger challenges by antitrust enforcers, although one antitrust enforcer has suggested that access remedies “may be necessary to unravel the competitive problems that have developed as a result of the STB’s and ICC’s policy of granting virtually every merger application.” The merits of any particular structural remedy are debatable, but in general structural remedies can mitigate the regulatory capture and procedural uncertainty that is endemic to case-by-case rate proceedings before the Board. As cumbersome as certain forms of “open access” mandates may prove, they could hardly fare worse than the McCarty Farms experiment in rate relief.

V. CONCLUSION

The story of McCarty Farms suggests a great tragedy in rural law: the original savior of the grain shipper, the Interstate Commerce Commission, eventually rescued the railroads on the backs of farmers. The Commission tried to avoid railroad failure at all costs and compromised its original regulatory mission to protect captive shippers. Yet the lessons from McCarty Farms are both narrower and broader than this. Narrowly, the project of captive shipper rate regulation did not fail simply to allow the railroads to succeed; after the deregulation and consolidation of the railroads, their revenues exceeded by orders of magnitude the recoveries denied to the small minority of shippers who were as captive to monopoly pricing as the McCarty Farms class members. There is little evidence that the Commission’s sacrifice of specific rate relief to overall revenue adequacy was necessary to sustain the railroad industry; the Commission itself never considered the question in McCarty Farms. More broadly, attempts at captive shipper rate regulation since 1980 failed because of a general tendency toward capture and complexity inherent in any model of centralized regulation. That model was compromised further by the Staggers Act’s bailout of a troubled industry by distorting its regulatory agency’s mission, rather than requiring or allowing the industry to restructure in response to effective regulatory and market pressures from consumers and competitors. As Congress again considers reforming the legal institutions that regulate the railroad industry—while it also responds to a new wave of troubled industries—the bailouts of yesterday may hold lessons for the bailouts of today.

238. Massa, supra n. 121, at 34–35.
239. Id. at 40.
240. Compare id. with Woodman & Starke, supra n. 218.