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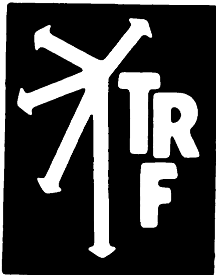

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The Transition to Deregulation: Developing Economic Standards For Public Policies

by William B. Tye
Westport, CT: Quorum Books, 1991

The Transition to Deregulation: Developing Economic Standards for Public Policy is based in substantial part on a series of articles published by William Tye in the early to mid 1980s. Most of these articles responded to recommendations of economists speaking for the rail industry (notably Princeton professors William Baumol and Robert Willig) about regulatory standards the Interstate Commerce Commission might adopt in implementing the Staggers Rail Act of 1980. [The non-rail oriented material includes two informative chapters on inflation and rate of return regulation and on effects of changes in regulatory tax treatment.] This material is updated, organized by subject matter, and formed into a treatise intended "to provide a framework for a scheme of regulation of industries undergoing a transition from traditional regulation to deregulation."

Transition covers much of the same material as the author's *The Theory of Contestable Markets*. It builds on Tye's own concepts of a proper regulatory framework, however, and provides more blow-by-blow detail on the past regulatory debates on these topics. Because many readers may find the collection of source articles in *Transition* somewhat repetitive and be distracted by the vintage nature of some of the dialog, unfamiliar readers may wish to read *Theory* first to gauge their interest in the theoretical issues discussed. Those familiar with the widely publicized theoretical work of Baumol and Willig, however, may want to go directly to *Transition* as the more exhaustive expression of dissenting views.

Despite the larger purpose of the *Transition* volume, readers should be prepared for immersion into the impassioned discourse on rail deregulation of the immediate post-Staggers Act period. Both advocates and opponents of substantial rail deregulation then saw the Staggers Act as creating the opportunity for carriers to improve their financial viability principally through increasing revenues, i.e. shipper rate levels. Economists consulting with the rail industry advocated first "Ramsey Pricing" and later "Stand Alone Costs" as ratemaking principles providing upward pricing flexibility. They supported application of these standards, moreover, only after a jurisdictional determination of "market dominance" based on a broad review of competitive factors. Liberal approval of end-to-end rail mergers, restricted use of trackage rights conditions, and loosening of "competitive access" guarantees were endorsed.

Economists consulting for shipper groups, including Tye, thought these proposals "eviscerated" protections for shippers that should be retained in transitioning to deregulation. The *Transition* volume expresses particular concern that shippers who relied on regulatory controls in locational decisions, investment allocations, and procurement commitments (and who had been prohibited by regulation from securing the protection of transportation contracts) could be exposed to abusive rail freight pricing. For practical and theoretical reasons *Transition* discusses in detail, Tye concluded that a Ramsey price cap or a specialized SAC ceiling (the cost of the individual shipper alone providing the transport service) would provide little protection for shippers. He also concluded that rail mergers and the elimination of ICC-mandated open gateways would entail vertical foreclosure problems. Tye considered contestability theory to be an unconvincing solution to competitive problems and contradictory with the efficiency rationale for end-to-end mergers. (In Tye's view, if the pre-merger market is competitive or contestable, inefficiencies should be eliminated; if inefficiencies persist, the market's contestability would be questionable prior to merger, and more so after the number of competitors is reduced).

Transition rejects strict application of efficiency maximizing economic prescriptions in favor of a broader "rule of reason" approach that incorporates considerations of equity. Tye's alternative to a rate making standard is what he calls a "contractual equilibrium" approach. This concept is less exhaustively developed than Tye's responses to railroad economists. However, it appears to call for extensive ICC intervention in shipper-carrier and intra-carrier negotiations

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as a kind of "honest broker" or mediator with the ultimate power to mandate agreements, in part employing rate-to-variable cost standards that Tye recommends. In this role, the ICC would (1) promote competitive incentives for efficiency and innovation, (2) encourage contracting to protect both buyers and sellers, (3) promote unbundling of services where this has a positive competitive effect, and (4) retain regulatory authority where contracts or competition appear unworkable in the near term. Rather than endorse any single set of formulas, standards or economic models, Tye envisions "a variety of possible or plausible contractual outcomes" with the guiding regulatory principle being to avoid "overtly opportunistic exploitation of a transitory situation bequeathed by previous regulation."

How do these perspectives square with the actual progress of rail deregulation? In fact, the ICC has not fully endorsed the approach of either the railroads' or shippers' economists, and has explicitly rejected approaches proposed immediately after deregulation. While deregulation spurred improvements in railroad financial viability, this can be attributed almost exclusively to cost reduction rather than to revenue enhancement under relaxed rate standards. Inefficiencies associated with the regulated rail industry were, in fact, so substantial as to produce major cost-saving opportunities. Thus, possible rail reliance on extreme differential pricing became a secondary concern. Rail rates per ton mile have declined in constant and current dollars, generally and across virtually all commodity categories, confounding the expectations of participants on all sides of the early post-Staggers debates. Rail marketers now advocate demand-based pricing, with little or no downward restrictions other than incremental costs, rather than pressing for higher Ramsey prices.

As a result of stable or falling rate levels (accompanied by a vast expansion of transportation contracting in lieu of tariff rates), many of the issues discussed in depth in the Tye volume now appear less relevant. Few market dominance complaints are arising and even fewer proceedings have been carried to a rate reasonableness determination. Legislative initiatives for reregulation or for mandated trackage rights or competitive access have largely faded. The movement toward rail mergers has slowed dramatically, with voluntary agreements becoming an increasingly popular vehicle for improving service quality and with spin-offs of major carriers far outnumbering their acquisitions. Recent rail industry conferences have explored further unbundling of rail services as means of improving efficient performance.

These outcomes occurred without the degree of ICC interventionism that *Transition* implicitly endorses. They do not, however, reflect a wholesale adoption of positions against which Tye earlier contested. For example, the ICC concluded the data on rail transport demand elasticities simply were not available with sufficient certitude to provide reliable regulatory standards based on Ramsey price computations. The ICC has also rejected the narrow, or "specialized" version of Stand Alone Costs (the costs associated with an individual shipper providing its transportation in isolation), against which Tye directed much of his arguments. It has instead adopted a broadened version of Stand Alone Costs (allowing multi-shipper movements over a selected hypothetical network) as the core rate reasonableness standard. This model continues to undergo refinement in the few rate reasonableness proceedings still before the Commission, and simplified SAC procedures are being propounded. While *Transition* also rejects this version of SAC as reintroducing joint cost allocation issues, and questions the practicality of establishing SAC boundaries in a manner that yields consistent and reliable results, this broadened regulatory tool appears intended to fairly balance the interests of railroads and shippers.

As being implemented, current SAC procedures are far closer to Tye's "rule of reason" approach than initial rail industry formulations of regulatory standards (although, in fairness, many viewed Ramsey Pricing as a general principle rather than a rigid regulatory rule). Although the jury may still be out on the long-term workability of the current SAC approach, the confrontation of railroad and shipper economists had a salutary effect on driving refinements to the stand-alone model. Tye's ability to detect internal contradictions in proposed economic standards played an important role. His observance of gaps between the information requirements of a given standard and the real world data problems that would undermine the effective application of that standard were also significant. Tye's astuteness as an intellectual critic are amply illustrated in *Transition*.

Although far less interventionist than *Transition* would recommend, the ICC also has adopted one of Tye's principal recommendations -- to eliminate potential competitive problems via promoting transport contracting. This was largely accomplished through retaining jurisdictional authority. As the decade proceeded, the ICC continued to accept evidence of any form of competition and rejected a rate-cost standard, but it nonetheless focussed on exceptionally narrow point-to-point markets and consistently found the presence of market dominance in the bulk of cases that were seriously litigated. Because of the combined threat of ICC intervention and the presence of competitive leverage not

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acknowledged by the Commission, all but a few of these cases were settled by the parties in advance of a rate reasonableness determination, with shippers obtaining lower, contract-assured rates. As a result, the more intrusive procedures Tye argued were essential to prevent exploitative rail pricing were not applied and have, to date, proved unnecessary.

In reading the *Transition to Deregulation* in the context of recent events, the reader can hardly escape the conclusion that the rail industry in the early post-Staggers period overstated the need for extreme differential pricing. At the same time, Tye's fear that the railroads would abuse permissive regulation appears exaggerated. His conundrum that vertical mergers could not both eliminate gross inefficiencies and still claim high contestability and the presence of workable competition, contains one crucial misperception. The structure of the rail industry immediately post-Staggers was not a product of competitive forces but a creature of regulation that restricted competition. Regulation, not the marketplace, created the rigid rate structures, related neither to costs nor to demand, against which shippers complained in the early 1980s. Because regulation largely was responsible for the existing economic inefficiencies in the rail industry, workable contestability (i.e., adequate competition) in a deregulated post-merger environment was not inconsistent with eliminating inefficiencies by reducing the number of participants inherited from a regulated market. Thus, the rail industry could "have it both ways" -- securing efficiency benefits of consolidation while retaining a competitive market. Ten years after deregulation, this outcome appears to have been substantially realized.

Transition to Deregulation provides serious conceptual challenges to prevailing economic theories, against which the proponents' works must be reviewed to reach measured conclusions. The volume is a valuable critique of tendencies to reduce the deregulatory process to a formalistic application of abstract economic models. At the same time, a healthy skepticism of formula-based approaches should not lead to excess and prolonged retention of regulatory rules as a substitute for market forces. Additional consideration of rail industry developments into the 1990s perhaps will lead to a further refinement of Mr. Tye's prescriptions.

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