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## U.S. Railroad Antitrust Immunity: Clarification, Discussion and Evaluation

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### Abstract

The U.S. Congress regulated the railroad industry in 1887, and over the course of the 20th century also granted the industry significant antitrust immunities. Antitrust immunities are laws that expressly exempt an industry from prosecution under antitrust laws, such as the Sherman Act. Presumably, the rationale for railroad antitrust immunities was that because railroads were stringently regulated, the regulators alone would uphold antitrust principles and make antitrust litigation unnecessary. However, culminating in the passage of the Staggers Rail Act of 1980, the railroad industry was largely deregulated, yet retained many antitrust immunities. This has raised concerns among shippers and consumers that railroad companies, which often face neither regulation nor antitrust liability, can freely commit anticompetitive abuses. Given these concerns and currently proposed legislation to abolish railroad antitrust immunities, the purpose of this paper is to evaluate the efficacy of legal outcomes in a counterfactual situation where antitrust immunities are abolished. To reach this end, I will first clarify railroad regulation and deregulation, antitrust laws as they apply to all other industries, and the poorly understood railroad antitrust immunities.

Antitrust laws ... are the Magna Carta of free enterprise. They are as important to the preservation of economic freedom and our free enterprise system as the Bill of Rights is to the protection of our fundamental personal freedoms.

Justice Thurgood Marshall (U.S. v. Topco Associates, 1972)

### 1. Introduction

In a purely competitive market, the number of buyers and sellers is so large that any one of them cannot affect the market price, which through competition is driven down to equal the marginal cost of production. If certain additional assumptions are valid, a competitive market maximizes efficiency and welfare for both producers and consumers (Bernanke & Frank, 2007).

Railroad transportation markets, however, deviate in several ways from the conditions necessary for purely competitive, efficient markets. First, due to the large expenditures required to start a railroad company, railroad companies often exhibit economies of scale. Economies of scale, which are often associated with behemoth firms, violate a requirement for competitive markets and mean that as production expands, average costs decrease. Firms with economies of

scale can drive smaller competitors into bankruptcy by using their low costs to temporarily decrease prices—only to raise them once the competition has been eliminated (a practice known as predatory pricing). Second, in any particular railroad market there is often an insufficient number of competitors for the market price to be driven down to its competitive equilibrium. A railroad market is defined as transporting commodity *X* from discrete locations *A* to *B*. It is usually not in a rail firm's interest to expend a significant outlay to build a rail line directly beside a competitors' rail line, so many railroad markets have a severe dearth of competition—often only one firm. Third, in addition to specific railroad markets, the overall railroad industry is exceedingly concentrated with four firms controlling nearly 90% of the freight traffic in the United States (S. Rep. No. 112-38, 2011). When these industry conditions are present, there is not sufficient competition to make the market efficient, and firms possess market power. Market power is the ability to charge prices above marginal costs, and it implies market inefficiency and welfare losses for consumers (Bernanke & Frank, 2007). Market power can be expressed through prices exceeding marginal costs or through other forms of anticompetitive conduct that will be further discussed in this paper.

When market power is present, there are two ways public policy can counteract the harmful consequences for consumers. First, statutory regulation can prescribe what is acceptable, such as direct price regulation. In Section 2, Railroad Regulation, I will discuss in greater detail the history of the statutory regulation of the railroad industry. Second, parties who are harmed by anticompetitive conduct can use the antitrust laws to sue for damages and injunctions in court. The antitrust laws are a collection of statutes that are intended to promote competition and thus reduce prices, and in Section 3, The Antitrust Laws, I will explain how they apply to virtually all industries.

In 1887, Congress created the Interstate Commerce Commission (ICC), a federal agency that, among other things, had the power to directly regulate railroad rates. The ICC's purpose was to stop firms with market power from raising prices above what would have prevailed in a competitive market. Throughout the 20<sup>th</sup> century, the railroad industry also accumulated antitrust immunities, which are laws that exempt an industry from prosecution under the antitrust laws. I will further explicate the railroad antitrust immunities, which have been called the “most convoluted story in American antitrust,” (Saggers, 2009) below in Section 4, Railroad Antitrust Immunities.

According to the U.S. Supreme Court, the rationale for railroad antitrust immunities was that the heavy ICC regulation alone would be “an effective safeguard against the evils attending monopoly, at which the [antitrust laws] are directed” (*Mclean Trucking Co. v. U.S.*, 1944). However, culminating in the passage of the Staggers Rail Act of 1980, Congress largely revoked the ICC's regulatory power over railroads and gave railroads more flexibility to set their own rates. Despite undermining the rationale for the immunities' existence by deregulating the industry, Congress retained the antitrust immunities. Without regulation or applicable antitrust laws, shippers and consumers are now concerned that railroad companies can freely exploit their market power to engage in anticompetitive conduct and raise prices above marginal costs.

Given these concerns, the purpose of this paper is to analyze the legal ramifications of a counterfactual situation in which antitrust immunities are abolished. To that end, I will first clarify railroad regulation and deregulation (Section 2 below), antitrust laws as they apply to other industries (Section 3 below), and the railroad industry's antitrust immunities (Section 4 below). This is an important and timely investigation because several industry developments are consistent with market power abuse, such as significant upward trends in rates and industry profitability since 2001 and several railroad practices that would arguably merit antitrust liability if not for the railroad antitrust exemptions (S. Rep No. 111-9, 2009). These concerns of market power abuse prompted members of the U.S. Congress to propose current legislation, the Railroad Antitrust Enforcement Act of 2011, to abolish all railroad antitrust immunities (S. 49, 2011).

## 2. Railroad Regulation

The first federal regulation of interstate railroads began with the Interstate Commerce Act of 1887, which established the Interstate Commerce Commission (ICC) that regulated railroad mergers, routes, and most important, rates (i.e., prices). Through direct regulation, the ICC attempted to set rates consistent with the public interest, and to curtail rate discrimination based on person, place, or length of haul considerations.

Though the authority was implied by the Interstate Commerce Act of 1887, the Hepburn Act of 1906 explicitly granted the ICC power to set maximum rates, and the Transportation Act of 1920 explicitly empowered the ICC to set minimum rates and to regulate all entry and exit of firms from railroad markets. By 1945, the ICC's regulation was expansive, including rates, line abandonment, service discontinuities, mergers, car flow, and interchange rules (Wilson & Burton, 2003), all of which Viscusi et al. (1998) note was "extensively used" (554). Therefore, in this era, federal regulators closely managed nearly all aspects of the railroad industry and widely used their authority to set maximum rates to counteract market power abuse, such as rates exceeding marginal costs. With such dominant regulation, antitrust laws were considered duplicative and unnecessary, so the railroad companies were exempted.

In the 1970s, the rise of competing alternative modes of transportation (truck and barge) and the inflexibility of ICC regulations – which constrained railroads from adequately adapting to the changing market conditions – lead to problems in the railroad industry. Railroad companies had deteriorating tracks, low productivity, poor financial performance, and many went bankrupt. In an attempt to revitalize the industry, Congress deregulated the railroad companies under the Rail Revitalization and Regulatory Reform Act of 1976 (4-R Act) and most importantly under the Staggers Rail Act (1980).

The 4-R Act established a "zone of reasonableness" within which railroads could freely set their rates, created easier procedures for abandoning routes, and eased merger restrictions. However, if the ICC found a firm to be "market dominant" (defined as controlling 70% of all traffic in a rail market or having revenue-to-variable cost ratio exceeding 1.8), then the ICC gained jurisdiction to conduct a rate reasonableness inquiry. If the rate was found unreasonable, the ICC prescribed rate regulation (Wilson, 1996). However, Winston, Corsi, Grimm and Evans

(1990) demonstrated that under the ICC's narrow application of the 4-R Act in the late 1970s, the legislation did not cause a significant change in the railroad regulatory regime, meaning the ICC still had overwhelmingly regulatory control of the railroad industry.

The Staggers Rail Act of 1980 most significantly deregulated the railroad industry. The preamble of the Staggers Rail Act states that it is the policy of the United States Government to "allow, to the maximum extent possible, competition and the demand for services to establish reasonable rates for transportation by rail" (49 USC §10101). Unless the ICC found a railroad to be "market dominant" and then found its rates unreasonable, railroads gained freedom to set their own rates. The Staggers Act also eased merger guidelines, facilitated abandonment of unprofitable segments of network as well as entry into new markets, and encouraged private, confidential contracts in rate setting. Essentially, for the first time since 1887, railroad companies gained the freedom to set their own rates. Coupled with a dearth of competition or the presence of economies of scale or both, this was an invitation for the railroad companies to use their market power to raise rates beyond marginal costs and therefore reduce consumer welfare.

The passage of the ICC Termination Act of 1995 replaced the ICC with a much smaller federal agency, the Surface Transportation Board (STB). The STB has jurisdiction to (1) adjudicate rate reasonableness cases brought by shippers against railroads, (2) prescribe new regulations, and (3) approve rail transactions, such as line sales, line construction, line abandonment, and mergers (Government Accountability Office [GAO], 2006). The STB does not directly regulate rates, so the only venue for regulatory relief from market power abuse is STB rate reasonableness adjudications. However, there is wide concern that the proceedings are "largely inaccessible," "expensive, time consuming, and complex" and may be financially prohibitive (GAO, 2006). Johnstone (2009) and Pittman (2010a) argue that the complexity, expense, and likelihood of failure in these proceedings have rendered them useless for most shippers. Indeed, on average it costs \$3.3 million over three years to litigate a rate reasonableness case (GAO, 2006), a price that is prohibitive for all but the biggest shippers.

In sum, the railroad industry transitioned from being heavily regulated in the first half of the 20th century to being significantly deregulated by 1980 and onwards. The ICC's forceful direct regulation once was a justification for antitrust immunities, but today the STB's ineffectual venue of rate reasonableness adjudication rarely constrains railroad company's pricing decisions. Coupled with antitrust immunities, this implies that railroad companies can exploit their market power to raise prices and engage in anticompetitive conduct.

### 3. The Antitrust Laws

#### 3.1. Statutory Fundamentals

The first major antitrust law was the Sherman Act of 1890, which has two foundational prohibitions:

Section 1: "every contract, combination ... or conspiracy in restraint of trade ...[is] illegal."

Section 2: “every person who shall monopolize, or attempt to monopolize, or ... conspire with any other person ... to monopolize ... shall be guilty of a misdemeanor.”

Section 1 governs mutual conduct, especially acts that coordinate sellers by the use of formal agreements. Mutual seller conduct, such as agreements to fix prices, is an expression of market power antithetical to competitive markets; instead of competing to lower prices, firms are conspiring to jointly raise prices. Likewise, monopolization is repugnant to competitive markets because monopolization is the process of forcing out competitors through illicit means, such as using economies of scale to engage in predatory pricing or undergoing mergers designed to reduce competition.

In 1914, the Federal Trade Commission Act (FTC Act) established the Federal Trade Commission (FTC), an agency designed to perform both investigatory and adjudicative functions. Section 5 of FTC Act created a foundational antitrust law, stating that “unfair methods of competition ... and unfair or deceptive acts” are illegal. The FTC has the power to determine what is “unfair” and issue cease and desist orders, which are binding in 60 days unless appealed in court. Only the FTC can bring cases under the FTC Act, and it can only apply civil penalties. However, this law is subject to a railroad antitrust exemption that is further discussed in Section 4: in the railroad industry, only the STB can enforce the FTC Act, not the FTC (15 USC §21[a]).

Perhaps in an attempt to define the vagueness of the Sherman Act, the Clayton Act (1914) explicitly prohibits four forms of conduct that were arguably implied by Section 1 of the Sherman Act’s prohibition on “restraint of trade.” The four forms of conduct prohibited by the Clayton Act are:

Section 2: price discrimination

Section 3: exclusionary practices (i.e., excluding a competitor by making it a condition of a purchase that the customer cannot later buy from a competitor)

Section 7: mergers “where the effect may be substantially to lessen competition, or to tend to create a monopoly”

Section 8: interlocking directorates

The Clayton Act also increased the available damages for violations of either the Sherman Act or the Clayton Act to treble damages (damages triple what makes the harmed party “whole”) and allowed for injunctions to prohibit specific conduct.

### 3.2. Judicial Interpretation

Based on these broad phrases and prohibitions, antitrust law in the U.S. is created through a common law process of precedents from courts and enforcement agencies to determine what practices are illegal in what situations. While private parties can sue under the Sherman Act and the Clayton Act, the main burden of enforcement falls on two government agencies: civil and criminal actions via the U.S. Department of Justice Antitrust Division, and exclusively civil actions via the Federal Trade Commission (Caves, 1994). Due to the nonspecific nature of the statutes, enforcement has gone through periods of high scrutiny to lax scrutiny. Below is a

survey of the law of (A) monopolization, (B) conspiracies in restraint of trade, such as price-fixing, and (C) select issues in exclusionary conduct.

### A. Monopolization (Section 2 of the Sherman Act)

As Viscusi et al. (1998) notes, Section 2 of the Sherman Act has been the most difficult antitrust law for courts to interpret, because the Sherman Act prohibits the process of monopolization but not necessarily the market position of being a monopolist. The market position of being a monopolist is traditionally defined as having a large market share, such as producing 60% of a particular good. Courts must balance the tension between discouraging anticompetitive monopolization without discouraging superior performance and efficiency that may lead to a monopoly.

In 1911, the Supreme Court had its first major test of how it would interpret Section 2 of the Sherman Act. Standard Oil Company and American Tobacco Company both controlled around 90% of their markets, and both firms used a wide range of aggressive conduct towards their rivals. For example, Standard Oil was accused of engaging in predatory pricing to drive competitors out of business by buying pipelines to foreclose crude oil supplies to rivals, securing discriminatory rail freight rates, and conducting business espionage. In *U.S. v. Standard Oil Co.* (1911) and in *U.S. v. American Tobacco Co.* (1911), the Court found both firms guilty under Section 1 and Section 2 of the Sherman Act and ordered their dissolution into several independent firms.

The most important consequence of these cases was the doctrine that the Court established to interpret the Sherman Act. The Court reasoned that the plain text of the Sherman Act was too extreme to be enforceable, and decided that not “every” restraint of trade or attempt to monopolize is illegal, but only those that are “unreasonable” or “injurious” (*U.S. v. American Tobacco Co.*, 1911). For adjudicating Sherman Act cases, determining what is a reasonable or injurious restraint of trade is known as the Rule of Reason doctrine. In *State Oil Co. v. Kahn et al.* (1997), the Court summarized the Rule of Reason:

... [Sherman Act] claims are analyzed under a ‘Rule of Reason,’ according to which the finder of fact must decide whether the questioned practice imposes an unreasonable restraint on competition, taking into account a variety of factors, including specific information about the relevant business, its condition before and after the restraint was imposed, and the restraint’s history, nature, and effect.

In *U.S. v. American Tobacco Co.* (1911) and *U.S. v. Standard Oil Co.* (1911), the Court ruled that the companies’ use of their large market share to engage in coercive actions against their rivals was unreasonable and therefore illegal, but also emphasized that high seller concentration alone need not necessarily be unreasonable.

In this era of monopolization jurisprudence, Sherman Act Section 2 violations were difficult to prove, prompting one commentator to call the law a “dead letter” (Gellhorn & Kovacic, 1994). For example, although U.S. Steel Corporation held 60% of the nation’s iron and steel capacity, in *U.S. v. U.S. Steel Corp.* (1920) the Court ruled that its acquisitions of competing companies were not an illegal attempt to monopolize. The Court’s reasoning was that “the law does not make

mere size an offense,” meaning that they interpreted Section 2 to not prohibit the market structure of monopoly, but only to prohibit the conduct of unreasonable monopolization.

The ruling in *U.S. v. Aluminum Co. of America (U.S. v. Alcoa)* (1945) effectively ended the previous Sherman Act Section 2 doctrine. Alcoa controlled 90% of U.S. aluminum production, and even without engaging in overtly unreasonable anticompetitive conduct, its size alone constituted a violation of Section 2 of the Sherman Act. Despite that Section 2 prohibits monopolizing but not monopolies, the Court argued, “A firm can gain and protect a monopoly position in ways more subtle than taking the bloody axe to its competitors.” They reasoned that Alcoa engaged in practices that were not overtly predatory, but still effectively resulted in monopolization of the market, such as building capacity ahead of demand to foreclose potential rivals. This ruling suggested that all companies with substantial market share were suspect, and perhaps presumably liable, for monopolizing under Section 2 of the Sherman Act.

Since the early 1970s, the courts have retreated from the encompassing approach of *U.S. v. Alcoa* (1945). In addition to a large market share, the courts are increasingly requiring that the conduct itself be an overt attempt to monopolize. Two major types of conduct that are potentially illegal monopolization are predatory pricing and refusal-to-deal.

Predatory pricing occurs when a firm, supported by economies of scale and a large market share, charges a price below marginal cost to force out competitors. This is illegal monopolization because the only possible benefit of charging a price where the firm is losing money is to bankrupt a competitor so as to later gain a monopoly position and then excessively raise prices. Refusal-to-deal monopolization occurs when a business reduces competition by refusing to sell to another business for the purpose of rendering them inoperable. Refusal-to-deal monopolization occurs if the plaintiff can prove:

1. The monopolist’s control of an essential facility (or product)
2. A competitor’s inability to reasonably duplicate the essential facility (or product)
3. The monopolist’s denial of use of the facility (or product) to a competitor
4. The monopolist’s feasibility of providing the facility (or product) (Gellhorn & Kovacic, 1994).

This is known as the essential facility doctrine, and it is intended to stop monopolists from exploiting their control of a resource to obstruct competition—such as a railroad firm owning the only track in a rail market and not letting others pay to use it. There is a fifth overriding, case-by-case consideration in all Rule of Reason analyses: whether or not the defendant advanced a reasonable business justification for denying access. If the defendant did advance a reasonable business justification for denying access, then they are not guilty of monopolizing under Section 2 of the Sherman Act.

In sum, monopolization jurisprudence is continually evolving. During the *U.S. v. Alcoa* (1945) era, having a dominant market share (as the four major railroad companies currently do) was sufficient for violation of Section 2 of Sherman Act. More recently, however, merely having a dominant market share is not enough to constitute monopolizing; the firm must also engage in

specific conduct deemed an injurious attempt to monopolize, such as predatory pricing or refusal-to-deal conduct.

### B. Conspiracies in Restraint of Trade (Section 1 of the Sherman Act)

Unlike the ebbing judicial interpretation of Section 2 of the Sherman Act, interpretation of Sherman Act Section 1 prohibition on conspiracies (agreements among would-be competitors) to restrain trade has been “the most unambiguous antitrust rule of law” (Viscusi et al., 1998). Per se illegal restraints of trade include:

1. Agreements to fix or maintain prices (U.S. v. Trenton Potteries Co., 1927; U.S. v. Socony-Vacuum Oil Co., 1940)
2. Agreements to limit output or productive capacity (U.S. v. Trenton Potteries Co., 1927; U.S. v. Socony-Vacuum Oil Co., 1940)
3. Agreements to share or divide markets (U.S. v. Topco Associates, Inc., 1972)

A per se violation of Section 1 of the Sherman Act means that it is automatically condemned as illegal, and is not subject to Rule of Reason deliberations about whether the act amounted to an unreasonable restraint of trade. These forms of conduct are so unambiguously adverse to competition and consumer welfare that courts automatically rule them illegal restraints of trade.

### C. Exclusionary Conduct (Section 3 of the Clayton Act)

Section 3 of the Clayton Act makes exclusionary conduct illegal. Exclusionary conduct occurs when a company requires buyers of its goods to refrain from purchasing goods from its rivals. Types of exclusionary conduct include tying agreements and exclusive-dealing arrangements.

Tying agreements occur when a company gives a buyer access to one of its goods only if the buyer takes others as well. The courts have enforced violations of tying agreements very strictly (Caves, 1994). To prove a tying agreement is illegal, the plaintiff must prove:

1. There are two distinct products
2. The seller has required the buyer to purchase the tied product in order to obtain the tying product
3. The seller has market power in the market for the tying product
4. The tying arrangement affects a substantial amount of commerce in the market for the tied product (*Grappone, Inc. v. Subaru of New England, Inc.*, 1988).

For example, in *Northern Pacific Railroad Co. v. United States* (1958) the Court found Northern Pacific Railroad guilty of a tying agreement because its sale of land adjacent to its rail lines required the purchasers to ship commodities only via their company.

Exclusive-dealing arrangements occur when a seller gives the buyer access to its goods only if the buyer agrees to not buy goods from any of the seller’s rivals. The courts have enforced violations of exclusive-dealing arrangements if dominant sellers use it to place newcomer sellers at a disadvantage (Caves, 1994), and in general, the Courts have treated them harshly (Viscusi et al., 1998). To evaluate the reasonableness of exclusive dealing, courts usually consider three factors: (1) the extent of market foreclosure, (2) the duration of the exclusive dealing, with

agreements less than one year “presumptively lawful” (*Roland Machinery Co. v. Dresser Industry*, 1984), and (3) the height of entry barriers (Gellhorn & Kovacic, 1994). If entry barriers to the market are small, the exclusive-dealing arrangement is likely to be legal; if entry barriers are significant (such as the large expenditures required to start a railroad), exclusive-dealing arrangements are likely to be found illegal.

#### 4. Railroad Antitrust Immunity

The railroad industry was exempted from antitrust laws in an era of direct railroad regulation under the rationale that the regulators alone would promote competition and avoid market power abuse. The antitrust exemptions for the railroad industry are disparate and complex, but nevertheless the exemptions are all in the United States Code and case law. Railroad antitrust exemptions apply only if the Surface Transportation Board (STB) regulates the firm or if the STB approves the action.

##### 4.1. Transactional Immunity

The Transportation Act of 1920 gave the STB exclusive purview over specified railroad transactions, and states that if a transaction is approved by the STB, it is exempt from antitrust laws (49 USC §11321[a]). Transactions that can be “approved or exempted” by the STB include mergers, acquisitions, leases, trackage rights (the right to use but not own rail lines), and joint ownership of rail lines (49 USC § 11323). Therefore, among other transactions, if a merger is approved by the STB, it is expressly exempt from challenge under Section 7 of the Clayton Act. This is a powerful immunity because it has permitted the industry to become extremely concentrated without allowing the Department of Justice to sue for antitrust violations. With four large railroads currently controlling 90% of the railroad market (S. Rep. No. 112-38, 2011), this immunity almost surely has shielded otherwise illegal mergers that “tend to create a monopoly” (Clayton Act).

##### 4.2. Rate Agreements

Enacted by the Reed-Bulwinkle Act of 1948, railroad rate agreements can be exempted from antitrust laws with approval by the STB (49 USC §10706[a][2][A]). If this exemption did not exist, the conduct would likely be a per se illegal violation of Section 1 of the Sherman Act, which prohibits conspiracies in restraint of trade, such as price fixing. Nevertheless, the antitrust exemption permits firms to coordinate their actions. When firms are permitted to coordinate their actions, they have an incentive to mutually raise prices.

##### 4.3. Rate Bureaus

The Reed-Bulwinkle Act of 1948 also allowed the creation of ‘rate bureaus.’ Rate bureaus are organizations of railroad firms where the companies discuss rates jointly. While rate bureaus are still legal (49 USC §10706[a][2][A]), their activities have been restricted to ameliorate the potential for anticompetitive collusion. Currently under 49 USC §10706(a)(3)(A), once the STB approves a rate, a member in that bureau cannot participate in discussions concerning another firm’s rates. Rail firms are also prohibited from discussing rates that another firm proposes for interline services “unless that carrier practicably participates in the movement” (49

USC §[a][3][A][ii]). Rate bureaus must report transcripts and audio recordings of all discussions to the STB. While these restrictions help reduce the potential for anticompetitive conduct in rate bureaus, it is nevertheless questionable why rate bureaus – would-be competitors jointly discussing rates – are exempt from antitrust laws.

#### 4.4. Interlocking Directorates

Under the Transportation Act of 1920, if the STB approves interlocking directorates for railroad firms – a practice otherwise prohibited by Section 8 of the Clayton Act – it is legal and exempt from antitrust challenge (American Bar Association [ABA], 2007). Interlocking directorates are individuals who serve on the board of directors of multiple corporations, which can lead to serious issues of conspiracies in restraint of trade among firms that are ostensibly competitors.

#### 4.5. Line Sales

The STB is authorized to review all sales, creations, and abandonments of railroad lines, and its approval immunizes the transaction from the antitrust laws (49 USC §10901). From the perspective of promoting competition, this immunity is problematic because it can allow a dominant firm to exploit smaller railroad companies to enhance its dominant position. For example, this exemption is the source of exclusionary conduct known as ‘paper barriers.’ In many line sales, major railroads divest track to regional operators that, after the sale, are connected with the seller’s main lines. In the line sale contract, the seller mandates that the buyer only interchange its traffic from the divested line to the seller, precluding the ability to interchange traffic with other railroads (ABA, 2007). If there were no antitrust immunities, this would be a patent violation of Section 3 of the Clayton Act, which prohibits just such exclusionary conduct that artificially reduces competition.

#### 4.6. Pooling Arrangements and Division of Traffic

The STB can approve combinations to pool or divide traffic, services, or revenues between carriers, which indirectly approves a rate agreement (49 USC §11322). If these divisions and pooling of revenues are approved, they are exempt from the antitrust laws (49 USC §11321[a]). If it were not for antitrust immunity, pooling arrangements would be prosecuted as conspiracies in restraint of trade under Section 1 of the Sherman Act. For all other industries, agreements between competitors to pool or divide business are per se illegal because they are adverse to competition (*U.S. v. Topco Associates, Inc.*, 1972).

#### 4.7. No Injunctive Relief for Private Parties

For other industries, under the Clayton Act (15 USC §26), private parties threatened with loss or damage by a violation of the antitrust laws can sue for injunctive relief in a civil action to enjoin an illegal activity. However, Section 16 of the Clayton Act prohibits private parties from suing railroad firms for injunctive relief under any antitrust law.

#### 4.8. The *Keogh* Doctrine: No Treble Damages for Private Parties

Under the *Keogh* doctrine (*Keogh v. Chicago & NW Railway Co.*, 1922), treble damages are unavailable for private shippers who challenge the reasonableness of rates submitted to the STB.

Along with the railroad's immunity from private party injunctions described above in Section 4.7, the *Keogh* doctrine narrows the scope of remedies that private parties can obtain against railroads under the antitrust laws to only singular monetary damages.

#### 4.9. Secretary of Transportation Conferences

Conferences among railroads, shippers, labor organizations, consumer representatives and government agencies may be convened by the Secretary of Transportation, and agreements entered into with the Secretary's approval through these conferences are exempted from antitrust laws (49 USC §333). This immunity grants opaque – and therefore dangerous – power to the Secretary of Transportation.

#### 4.10. Federal Trade Commission Act Enforcement

The Federal Trade Commission Act (FTC Act) prohibits “unfair methods of competition ... and deceptive acts” in commerce, and establishes that the Federal Trade Commission (FTC) is the exclusive enforcer of the law. However, Section 5 of the FTC Act (15 USC §45) states that the FTC cannot enforce the law against railroads; rather, the STB has sole authority to enforce compliance with the FTC Act against railroads (15 USC §21[a]). This sweeping antitrust exemption entirely removes one of the foundational antitrust laws from enforcement by any party besides the STB.

To summarize, railroad antitrust exemptions apply if a firm is under STB jurisdiction or if the STB approves the action. Therefore, the STB essentially has exclusive control of anticompetitive issues in the railroad industry, which is why the STB has been described as a “surrogate” to antitrust laws (ABA, 2007). However, the deregulated STB is “largely inaccessible,” “time consuming, and complex” (GAO, 2006), and its proceedings are financially prohibitive for the vast majority of shippers (Johnstone [2009] and Pittman [2010a]). Given this, it is problematic that there is no recourse for those who believe that the STB's decisions will be adverse to competition except general rules of administrative procedures (Brennan, 2009).

### 5. Analysis of the Counterfactual: No Antitrust Immunities

I have described the historical and current regime governing the railroad industry. Because presumably some form of government intervention is necessary to police the naturally monopolistic railroad industry, the efficacy of this particular regime of government intervention in railroad markets is an important investigation. There is a wide literature on the positive effects of the Staggers Rail Act deregulation (summarized in GAO, 2006), so it is not efficacious to have a federal agency heavy-handedly manage industry and establish rail rates (as the ICC did prior to the Staggers Rail Act). However, what is less clear is the desirability of antitrust immunities. What would happen in the railroad industry if there were full antitrust liability, as in virtually all other industries? This is an important consideration because members of the U.S. Congress recently proposed the abolishment of all railroad antitrust immunities in the Railroad Antitrust Enforcement Act of 2011 (S. 49, 2011).

The literature addressing what would happen if antitrust immunities were repealed is limited (Pittman [2010b], Brennan [2009], Massa [2001], and Saggars [2009]). The Staggers

Rail Act deregulation, in combination with continued antitrust immunities, has engendered several deleterious anticompetitive issues for a minority of ‘captive shippers.’ Even though deregulation under the Staggers Rail Act increased welfare in significant ways, it does not necessarily imply that application of the antitrust laws could not further increase welfare by ameliorating specific anticompetitive conduct that is harming certain shippers. Two important anticompetitive issues are refusal-to-deal in ‘bottleneck’ markets, and exclusive-dealing contracts known as ‘paper barriers.’ A third crucial consideration is the overall concentration of the railroad industry. In what follows, I consider what would occur in the counterfactual situation of abolishing antitrust immunities.

### 5.1. Refusal-to-Deal in ‘Bottleneck’ Markets

Many rail customers, known as “captive shippers,” are served by only a single railroad at either their origin or destination. However, over some portion of the captive shipper’s route, another railroad could compete for the shipment service. This market is illustrated in Figure 1:

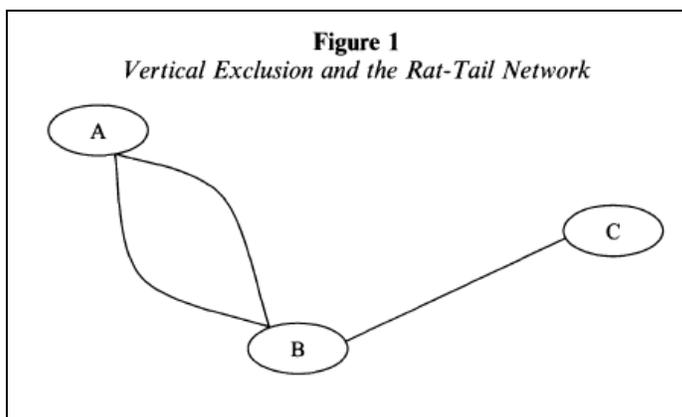


Figure 1. Such rail markets are called “bottleneck markets” because the portion from B to C narrows to just one rail provider, like the neck of a bottle narrows. Source: Wilson and Burton (2006).

Consider a shipper at *C* who needs to ship a product to *A*. From *C* to *B* the shipper is captive to a pure monopolist, but from *B* to *A* there could be two firms competing to lower rates. Currently, the monopolist who controls *C* to *B* forecloses the possibility of competition on the segment from *B* to *A*. The monopolist achieves this by either refusing to grant trackage rights over *C* to *B* to other railroads, or refusing to offer a route that would stop at the point where the carrier could be switched to allow for competition (i.e., only offering *C* to *A* and refusing to offer *C* to *B*). The STB approved these tactics to hold a shipper captive over an entire route, so the conduct gained antitrust immunity (*Central Power and Light Co. v. Southern Pacific Transportation Co.*, 1997).

There is a consensus in the literature that captive shippers pay higher rates than non-captive shippers, which suggests captive shippers’ rates are affected by market power abuse (GAO [2006], S. Rep. 111-9 [2009], Ellig [2002], Sagers [2009], Brennan [2009], Pittman [2010b], and S. Rep 112-38 [2011]). Grimm and Winston (2000) estimate that captive shippers pay rates which are 20.9% higher than non-captive shippers. If there were no antitrust immunities, these

practices would be evaluated as refusal-to-deal monopolization violations of Section 2 of the Sherman Act, or as tying arrangements violations of Section 3 of the Clayton Act.

Refusal-to-deal violations of Section 2 of the Sherman Act occur when a business refuses to sell to another business or consumer for the purpose of driving the other business into bankruptcy or to raise prices for the consumer. However, the Court ruled in *Verizon v. Trinko* (2004) that refusal-to-deal would be illegal only if the firm was stopping a practice it had formerly been undertaking, and the firm would lose profits by stopping the practice (except for longer-run monopolist benefits). In addition, in *Monsanto Co. v. Spray-Rite* (1984), the Court ruled that a seller “has a right to deal, or refuse to deal, with whomever it likes, as long as it does so independently.” Under this case law, refusal-to-deal violations are rare and difficult to prove (Pittman, 2010b).

In *Verizon v. Trinko* (2004) and *Monsanto Co. v. Spray-Rite* (1984) the essential facility doctrine, which proves refusal-to-deal monopolization, was not relevant; in bottleneck railroad markets, however, the essential facility doctrine is highly relevant. The essential facility doctrine holds that for refusal-to-deal monopolization to be present, the plaintiff must prove (1) the monopolist controls an essential facility, (2) competitors are reasonably unable to duplicate the essential facility, (3) the monopolist denies use of the facility to a competitor, and (4) the monopolist could feasibly provide the facility (Gellhorn & Kovacic, 1994). Based on these criteria, if antitrust immunities were abolished, the refusal-to-deal conduct of the initial rail monopolist would be illegal monopolization. That is, the railroad firm that is a monopolist over *C to B* controls an essential facility (the monopoly route); there are prohibitive costs for a competitor to construct a competing line over that segment; the monopolist denies the potential competitor trackage rights; and the monopolist could feasibly offer those trackage rights. In sum, if antitrust immunities were abolished and the plaintiff could successfully argue that the essential facility doctrine is the relevant authority, the conduct in bottleneck markets would be illegal under Sherman Act Section 2 as refusal-to-deal monopolization.

An alternative way to prosecute conduct arising in bottleneck markets is through a Clayton Act Section 3 lawsuit that alleges a tying agreement. Tying agreements occur when a seller gives a buyer access to the seller’s service only if the buyer takes other services as well. For the shipper in Figure 1, a railroad only offering shipping from *C to A* could be framed as a tying arrangement. If a shipper uses *C to B*, then they are forced by necessity to also use *B to A*. This is a plausible argument, and tying agreements supported by market power have been enforced strictly (Caves, 1994). As outlined in *Grappone, Inc. v. Subaru of New England, Inc.* (1988), for a tying agreement to be found illegal, the plaintiff must prove: (1) there are distinct services, (2) the seller has required the buyer to purchase the tied product in order to obtain the tying product, (3) the seller has market power in the market for the tying product, and (4) the tying arrangement affects a substantial amount of commerce in the market for the tied service. The monopolist railroad company has market power, and a substantial amount of commerce is involved in any given railroad market, so conditions (3) and (4) are satisfied. What is debatable is whether the railroad is offering two services (*C to B* and then *B to A*) or only one service (*C to A*). If the railroads were to be found in violation of the Clayton Act Section 3 for a tying agreement, the plaintiffs would need to successfully portray the two segments as distinct

services that were tied together solely for the purpose of excluding the competitor. Given the empirical evidence of higher rates for captive shippers, it is a convincing argument that two independent lines are joined for the purpose of exploiting market power to increase rates.

In sum, railroads holding shippers captive over portions of track where competition could prevail is anticompetitive. This conduct could be prosecuted as a refusal-to-deal offense under the essential facility doctrine (Sherman Act Section 2) or a tying arrangement violation (Clayton Act Section 3). If antitrust immunity were removed, litigation would expose the details of these issues to determine legality of conduct. Moreover, as Pittman (2010b) suggests, the mere threat of this litigation could force railroads to negotiate lower rates rather than risk going to court for potentially exploiting captive shippers.

## 5.2. Exclusive-Dealing Contracts

One goal of the Staggers Rail Act was to decrease regulations that prevented the “rationalizing” of rail lines, which means selling or abandoning unprofitable lines. Due to these deregulations, large and dominant railroads have leased or spun-off portions of track to form smaller regional short line railroads. These transactions often come with contractual conditions – called ‘paper barriers’ – that require the new buyer of the line to only engage in transit with the previous owner. Line sales are under the STB’s jurisdiction, so it has the power to reject these transactions if it believes they are contrary to the public interest. However, the STB has regularly approved these contracts, which then immunizes them from antitrust laws. These contracts are anticompetitive because they decrease shipper’s options and expose them to a firm with increased market power. The contractual barriers are additionally inefficient because they result in idle short line capacity even though market demand would otherwise provide productive opportunities.

If antitrust immunity were removed, these paper barriers could be prosecuted under Section 3 of the Clayton Act as tying arrangement or exclusive-dealing violations. As outlined in the bottleneck market context, for a tying agreement to be found illegal, the plaintiff must prove: (1) there are distinct services, (2) the seller has required the buyer to purchase the tied service in order to obtain the tying service, (3) the seller has market power in the market for the tying service, and (4) the tying arrangement affects a substantial amount of commerce in the market for the tied service (*Grappone, Inc. v. Subaru of New England*, 1988). Based on these criteria, paper barriers would be illegal tying arrangements because the seller is tying the sale of its line to its transit service.

A second way paper barriers would be illegal is as exclusive-dealing contracts in violation of Section 3 of the Clayton Act. Exclusive-dealing arrangements occur when a seller gives the buyer access to its goods only if the buyer agrees to not buy goods from any of the seller’s rivals. The courts have enforced violations of exclusive-dealing arrangements if dominant sellers use it to place newcomer sellers at a disadvantage (Caves, 1994), and in general the courts have treated them harshly (Viscusi et al., 1998). To evaluate the reasonableness of exclusive-dealing contracts, courts usually consider three factors: (1) the extent of market foreclosure, (2) the duration of the exclusive dealing, and (3) the height of entry barriers (Gellhorn & Kovacic, 1994). Under these criteria, with antitrust immunities abolished, paper barriers would be illegal

exclusive-dealing violations because they force the buyer of the short line to not do business with the seller's rivals; they indefinitely foreclose the market; and they establish significant barriers of entry for competition.

Whether as a tying agreement or an exclusive-dealing agreement under Section 3 of the Clayton Act, if antitrust immunities were abandoned the railroad industries' paper barriers would face antitrust liability. Judicial scrutiny and any appropriate remedies, such as injunctions enjoining the practice, would be welcomed. Shippers who are currently forced to use a monopolist provider to gain access to short lines under paper barriers would enjoy the benefits of increased competition—principally, lower rates.

### 5.3. Mergers and Industry Concentration

Under the STB's approval of mergers, the U.S. railroad industry has been extensively consolidated: four major railroad companies currently control nearly 90% of the market's revenues (S. Rep. No. 112-38, 2011). This is an astonishing lack of competition, and suggests that railroad companies are not robustly competing to bid down rates. Indeed, in the last decade the four largest railroad firms have annually raised their rates 5% above inflation and have increased their profit margin to 13%, making railroads the fifth most profitable industry in the U.S. (S. Rep. No. 112-38, 2011). This directly harms shippers but also consumers by raising the price of the goods that are shipped, such as foodstuffs and coal for electricity.

The mergers that created the concentration of the railroad industry are exempt from antitrust laws because they were approved by the STB. However, if antitrust immunities were abolished, there would likely be colossal confrontations in court brought by the Department of Justice (Pittman, 2010b) to determine whether the mergers amounted to monopolization under Section 2 of the Sherman Act, or violated Section 7 of the Clayton Act, which prohibit mergers where "the effect may be substantially to lessen competition, or to tend to create a monopoly." A plain reading of this law implies that the mergers would be found illegal, and the firms could be ordered to break into smaller firms that compete with each other. This would help avoid the market power abuse that leads to increased prices for all consumers.

### 5.4. Other Legal Effects of Antitrust Immunity Repeal

If antitrust immunities were revoked from the railroad industry, their rate agreements and rate bureau exemptions would be illegal under antitrust law. For example, this would permit a shipper who alleged a rate was excessive due to a collusive rate agreement to sue the railroad under Section 1 of the Sherman Act. Additionally, the current railroad arrangement to pool and divide traffic would be illegal under antitrust law, namely as an illegal market allocation under Section 1 of the Sherman Act. With antitrust immunity abandoned, the FTC would be allowed to prosecute railroad companies under the FTC Act, which prohibits "... unfair or deceptive acts or practices in or affecting commerce..." (15 USC § 45). Given the breadth of the phrase "unfair or deceptive acts," this could entail nearly any conduct that the FTC deems anticompetitive, such as bottleneck market tactics designed to make shippers captive to one company. Lastly, if antitrust immunities were abandoned, the remedies available to private parties would be expanded to include injunctive relief and treble damages, which would encourage more antitrust lawsuits and thus less market power abuse.

## 6. Conclusion

The regime governing the railroad industry since 1980 – a deregulated federal agency coupled with broad antitrust immunities – in some ways has presided over a period with significant improvements in railroad industry conditions, such as productivity gains and restored financial health. However, extensive industry consolidation is likely responsible for rising prices, and some specific complaints remain for shippers who have excessively limited transportation options. If antitrust immunities were repealed, shippers with grievances (especially captive shippers in bottleneck markets and shippers subject to paper-barriers from line spin-offs) would be able to sue railroad companies for violations of antitrust laws. If the facts substantiated the allegations in the courts, then the result would be a more competitive and efficient railroad market because courts would enjoin railroad conduct that reduces competition.

Antitrust immunities were initially implemented because at the time there was a federal agency that resolved anticompetitive concerns with aggressive regulation. However, now that the industry has been largely deregulated, there is not a sufficiently accessible or responsive mechanism for responding to anticompetitive conduct. By removing antitrust immunities, as members of the U.S. Congress have currently proposed in the Railroad Antitrust Enforcement Act of 2011 (S. 49, 2011), the industry would couple deregulation with a more logically consistent application of the antitrust laws. Under this new regime, as in virtually all other markets, market forces would determine prices, entry, and exit. Furthermore, in the spirit of Justice Thurgood Marshall's principle that antitrust laws are "the Magna Carta of free enterprise" that are fundamental "to the preservation of economic freedom and our free enterprise system" (*United States v. Topco Associates, Inc.*, 1972), if any firm used market power to abuse the competitive marketplace, antitrust lawsuits would be an available remedy to make the marketplace efficient and fair.

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