TRADE RESEARCH CENTER

Montana State University
Bozeman

The Economics of World Wheat Markets: Implications for North America

May 29–June 1, 1997

Conference Proceedings

October 1997

Objective Analysis
for Informed
Decision Making

Railways, Competition, and the Hold-up Problem

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Grain transportation is an important economic issue for grain producers in the Northern Plains and Rockies region. Reliance on export markets and long distances to port positions mean transportation costs have a significant effect on the price received by farmers.

In the prairie region of Canada, rail transportation is undergoing a major transformation. Some deregulation has occurred and further deregulation is being considered. Some parties, including the railways, argue that a deregulated system, similar to the U.S. system, is the only way to achieve transportation efficiencies. Other groups, supporting the status quo, argue that the regulation of rates is essential to control the monopoly power of the railways. There has been very little discussion of other policy options, with the exception of a limited discussion of nationalized railbeds.

Further deregulation of rail transportation is under consideration for the Canadian prairies. The U.S. experience provides a stark view of deregulation.

The U.S. experience provides a very stark view of the likely outcome of a deregulated system. When railways are not faced with competition, the evidence suggests they will price freight services at or near competitive truck rates. As Figure 10 shows, freight rates in Montana, where no competition exists, are approximately twice those at Kansas City and Denver/Commerce City, where effective rail and/or barge competition exists.

The current cost-based regulated rates in western Canada are similar to those at Kansas City and Denver/Commerce City. Given similar distances to port and the existence of only two railways (and no likelihood of new entrants), deregulation in western Canada seems likely to result in freight rates closer to those in Montana than to the current regulated levels. The increase implied in freight costs would result in transfers from producers to the railways, distort production incentives, and create losses elsewhere in the economy.

The other option, to maintain a regulated freight rate structure, would also create difficulties. The lack of price signals would reduce the incentive for industry participants to perform. For example, branch lines are less likely to be maintained in a regulated environment because railways may be unable to charge the extra amount necessary to make them viable. Railways may also disrupt the system— as a form of bargaining—to create pressure for deregulation. Finally, the uncertainty created by the possibility of switching to a deregulated system may cause industry participants to be reluctant to make investments that rely on regulated freight rates.

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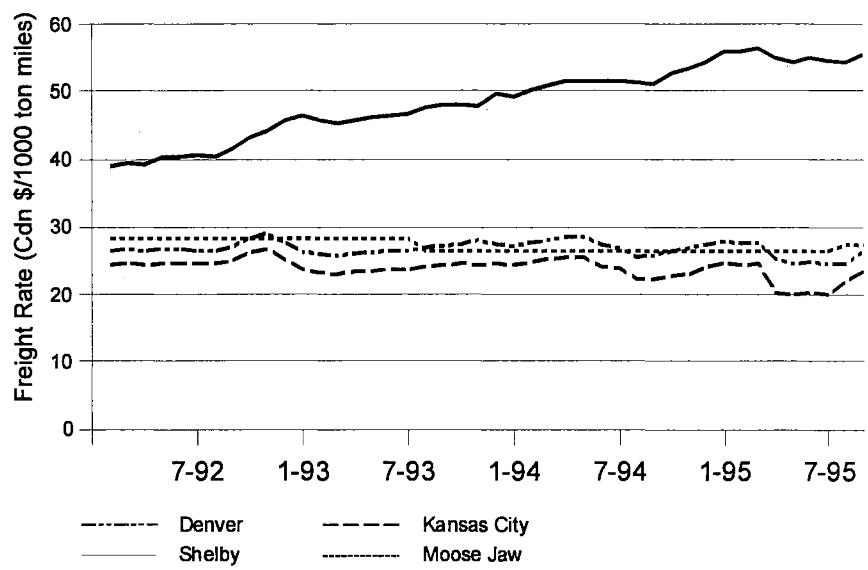
Figure 11. Freight Rates for Wheat, Selected U.S. and Canada Points 1992-1995



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It is difficult to regulate a concentrated industry in which entry is difficult for new firms. The result is policy uncertainty and various forms of investment hold-up. Addressing the problem through regulation of entry rather than regulation of behavior may be a more effective longterm solution to the control of natural monopolies. Regulating entry would use competitive forces to develop a more efficient system.

Entry regulation has been introduced in industries outside of transportation. For instance, in the field of telecommunications, regulations have been introduced to force local companies to carry long distance services from other companies. This has resulted in dramatic reductions in the cost of long distance services. Similarly, electrical utilities are being forced to carry current from other suppliers to their customers, which has eliminated their monopoly over their customers and has given them an incentive to find lower-cost technologies.

This option is available for the rail industry. For example, in Britain, the ownership of railway tracks has been separated from the operation of the rail equipment and the provision of service. Ownership of the tracks rests with a company called Railtrack (Railtrack is currently government owned but will be privatized). Railtrack leases access to thirty train operators for fees that are regulated by the Office of the Rail Regulator to cover maintenance costs and provide a return on investment. The thirty rail operators then compete to provide service to customers.

Similar models need to be developed and articulated before they can be considered in the public policymaking framework. Nevertheless, given the importance of rail transportation to the grain industry, it is imperative that such options be investigated to address the very tricky and thorny issues of freight rates and transportation efficiencies.

About the Authors

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